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BusinessWeek

MBER 6, 2004

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BUSH'S AGENDA

Selling America
on the Ownership
Society

» How will the
Investor Class vote?

» Sizing up his
economic record

» A talk with
Treasury's John Snow

(P.34)

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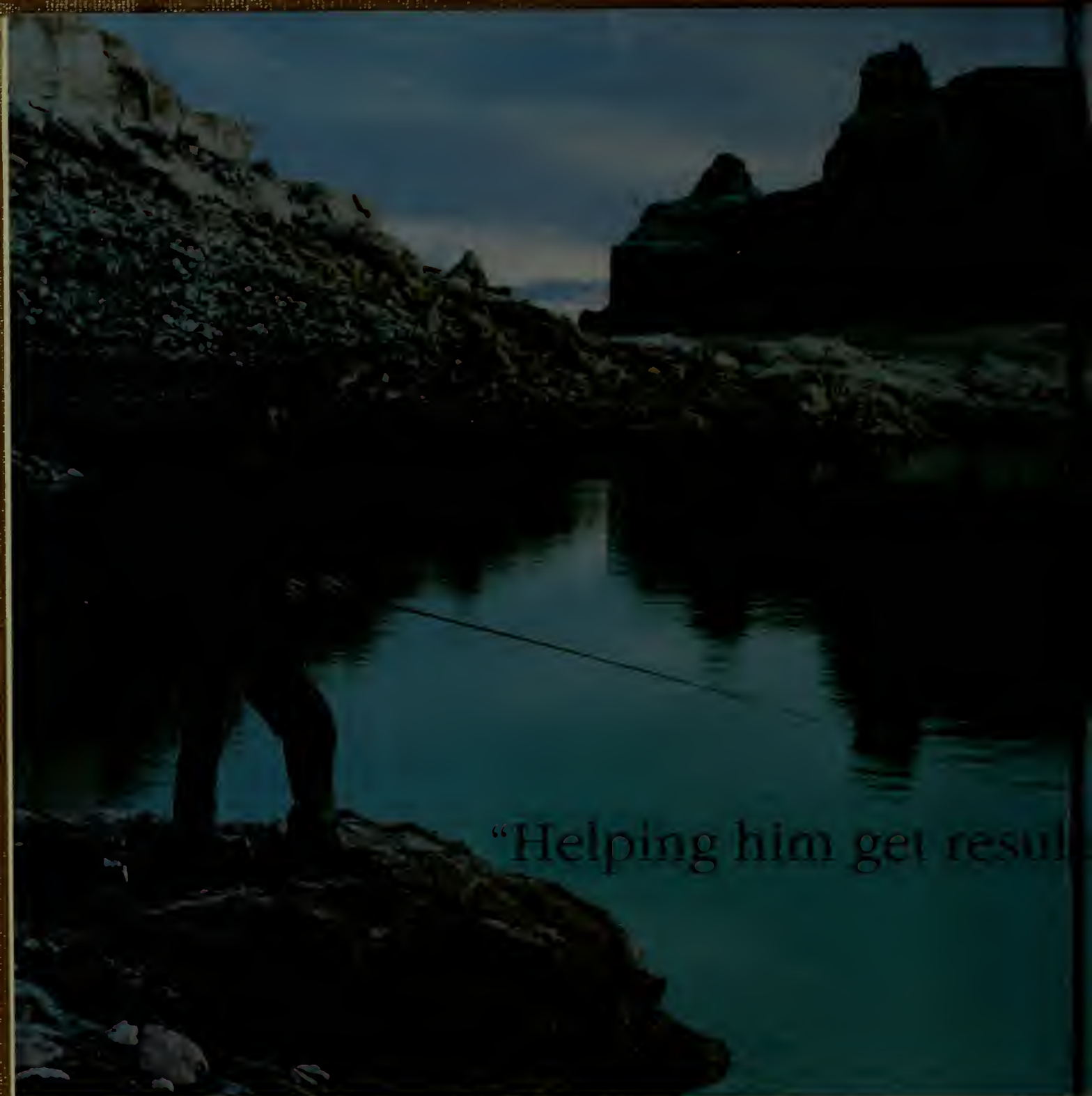
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He invented much of modern computing, including hypertext—the HT of HTML—but didn't benefit much



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Where Technology Could Bubble Next Year

With the arrival of a new version of Windows and next generation video-game boxes still a long way off, the tech industry looks stuck in neutral. But some promising products could give it a lift in 2005



The Good News About Costly Oil

With oil prices surging, some fear the age of cheap energy is coming to an end. Expect prices to come down slowly, says S&P Chief Economist David Wyss. But if they don't, fear not—even a \$75 a barrel, the U.S. wouldn't see a recession

Comcast: More Than Buffett Is Behind the Recent Runup

Whether or not it was Warren Buffett who made the call at Berkshire Hathaway to buy 5 million shares of Comcast, chances are it was a good call, given the cable giant's prospects



Telcos Get a Message from Beijing

Sanctions levied on Chinese wireless-service providers by China Mobile were clearly made at the government's behest, and it shows just how little power these entrepreneurial outfits have in China's schizo regulatory scheme

Bush or Kerry: The Impact On the Stock Market

Some market strategists are well into the game of figuring which sectors win and which sectors lose under either possible President



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"One of the first 'smart' phones that lives up to the description."

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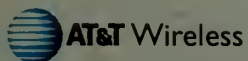
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This is huge.

Treo 600

As you can see, the new Treo™ 600 smartphone from palmOne has been a big hit with some very big names. Which isn't surprising when you consider what you're looking at. It's a full-featured mobile phone that's also a Palm Powered™ organizer and a digital camera. And with a choice of wireless service providers the Treo 600 offers email, text messaging, and web browsing. But the biggest news is that all this comes in a small, sleek device you can slip in your pocket and stay connected wherever you are. And that really is huge. To find out more, go to www.palmOne.com or visit your local service provider.



The Wall Street Journal, 12/11/03. The New York Times, 12/18/03. BusinessWeek, 12/15/03. Wireless service plan required. Email and web require data services and ISP, and additional charges apply. Wireless coverage may not be available in all areas. Screen image simulated. ©2004 palmOne, Inc. All rights reserved. palmOne, Treo, and Palm Powered are among the trademarks or registered trademarks owned by or licensed to palmOne, Inc. All other brand and product names are or may be trademarks of, and are used to identify products or services of, their respective owners.

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"Freedom means freedom for everyone."

—Vice-President Dick Cheney, whose daughter Mary is a lesbian, opposing a Constitutional amendment banning gay marriage

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HONCHOS A RARE MEA CULPA FROM BARRY DILLER

SAY THIS MUCH for Barry Diller: The man doesn't run and hide when things go wrong. The oft-combative CEO of IAC/InterActiveCorp has taken his lumps from Wall Street since second-quarter earnings on Aug. 3 missed analysts' revenue targets in IAC's key online-travel business. And Diller made things worse when he got testy under questioning during the post-earnings analyst conference call.



OFF TARGET Taking lumps on the Street

But in an Aug. 5 e-mail to IAC employees, which Diller provided to *BusinessWeek*, he took the blame for what he called a "lame" and "far too

defensive" performance. Diller told workers the problem was that he and top execs set expectations too high at a November, 2003, investor day. "The higher truth is we did disappoint the estimates for growth set by our own hands," Diller wrote.

In a gesture that may please critics who fear Diller will make acquisitions that

dilute IAC's stock, the note also signals that IAC's growth plans are focused on existing businesses, such as pushing into the nascent Asian e-travel market. But the road back to Wall Street's good graces may not be short or smooth: IAC shares, at \$24.23,

are still down about 43% from their peak in July, 2003.

—Timothy J. Mullaney

For Diller's full e-mail go to www.businessweek.com/bwdaily



JOB WATCH

Brass Rings For New MBAs

FINALLY, SOME GOOD NEWS for MBA graduates. Driven by an unexpected hiring surge from consulting firms and banks, an estimated 85% of graduates at *BusinessWeek's* Top 30 Business Schools secured jobs by graduation day, up from 65% last year. "We didn't expect a whole lot, but this year surprised us," says Matt Merrick, director of MBA career services at **Harvard Business School**. Salaries and bonuses also have edged up. Students say that the rate for a consulting slot is up about 5%, to \$105,000—with a signing bonus of around \$15,000.

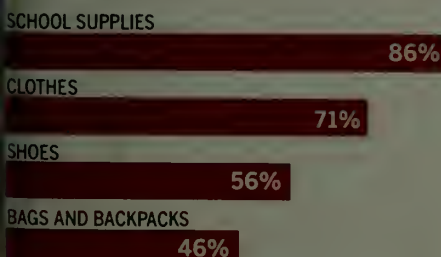
Investment banks and consultancies—which typically hire 65% of all top MBA grads—seem to be gaining enough confidence in the business climate to boost hiring. At Northwestern's **Kellogg School of Management**, for instance, **McKinsey** took on 54 students by graduation this year, up from 40 in 2003.

Will it last? Consulting firms are planning more fall interviews than last year. But most employers have moved toward "just-in-time" hiring in the spring instead of hiring in the fall. Students may have to wait a little longer to find out if they have jobs. Still, a delay is better than having to pound the pavement all summer.

—Jennifer Merritt

THE BIG PICTURE

BACK TO SCHOOL Here is the percentage of parents who plan to shell out for:



Data: NPD Group survey of 18,000 consumers taken July 22–Aug. 6



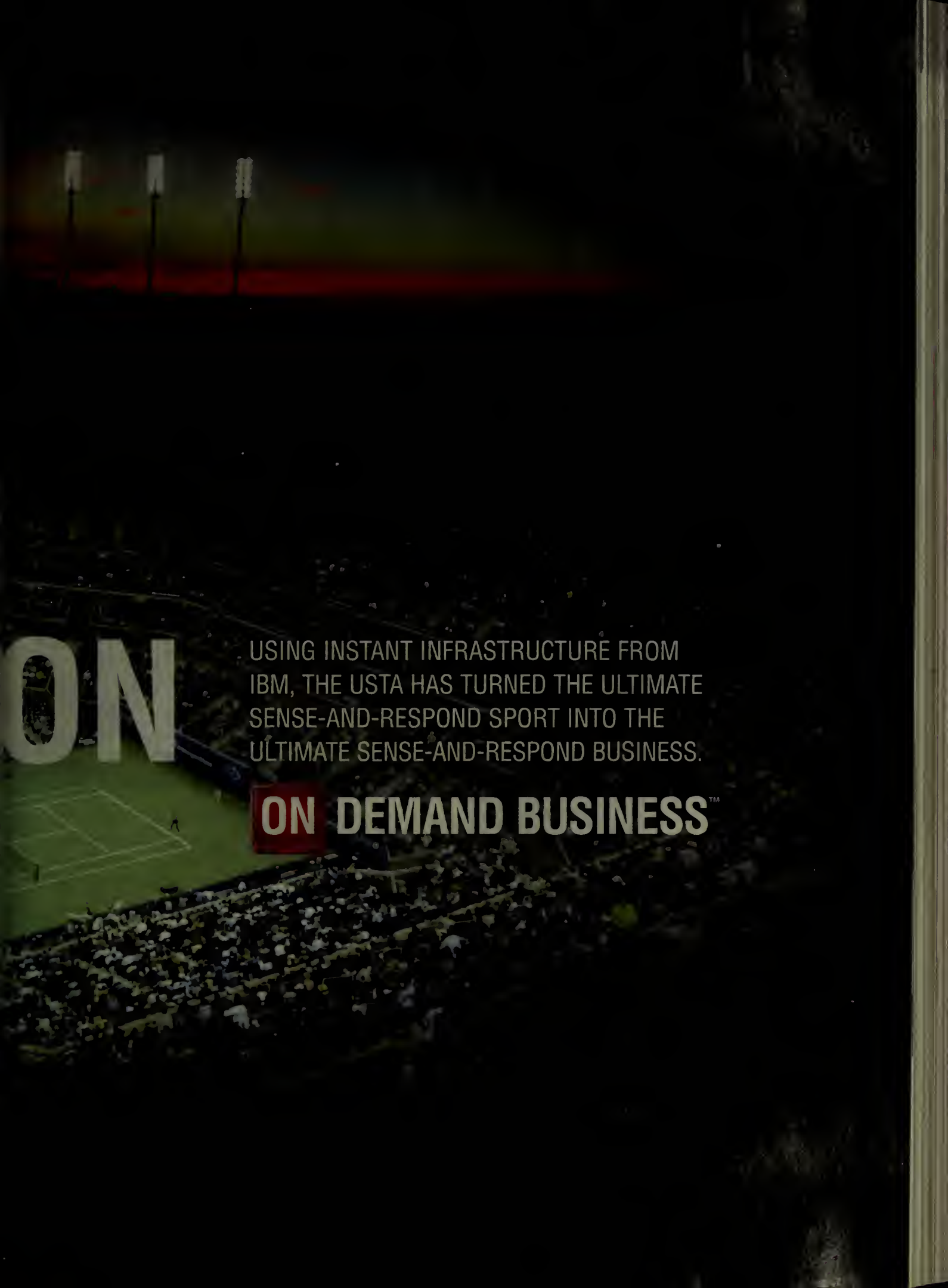


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BORDER PATROL FAKE CIGGIES GO INTO WITHDRAWAL

IS YOUR CIGARETTE genuine? A recent **Government Accountability Office** report says counterfeit smokes are now the item most often seized by **U.S. Customs** over knockoff handbags, watches, and apparel. While \$5 million worth of bogus butts were

stopped at the border in 2001, the total leaped to \$45 million in 2003. The rise is mainly attributed to state and local tax hikes on cigarettes—as much as \$3 per pack in New York City. “[It’s] a significant profit motive,” says Jack Holleran of **Philip Morris USA**.

Many of the bogus cigs hail from China, where organized crime has the wherewithal to produce and smuggle them for sale on the black market, says Jerry Bowerman of the Bureau of Alcohol, Tobacco, Firearms, and Explosives (ATF).

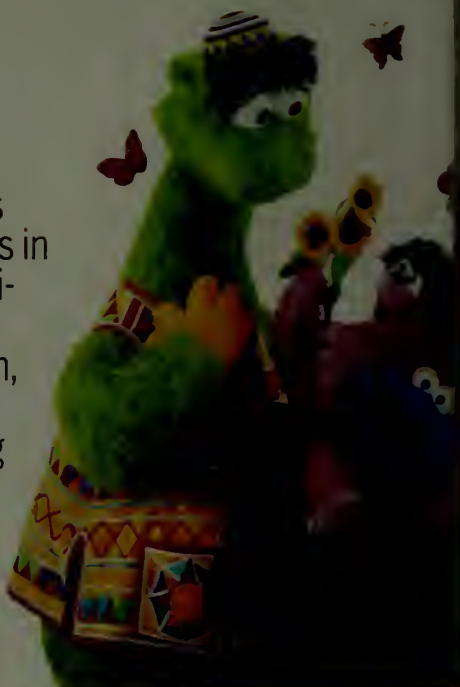
Help could come soon. The Prevent All Cigarette Trafficking Act would give the ATF the ability to sell counterfeits undercover and would lower the felony threshold for smuggling from 60,000 cigarettes to 10,000. Unfortunately for smokers, lowering taxes hasn’t been discussed. —*Brian Hindo*

SHOW BIZ

CHILD’S PLAY

Sesame Street’s newest shingle is in Afghanistan. Episodes from the Egyptian version, translated into Dari, are playing at schools, women’s centers, and orphanages.

Koche Sesame, as it’s called, teaches literacy and hygiene. Women’s rights, too, are emphasized through the star—Gulabi, an ambitious, pink female Muppet who dreams of a career as a doctor or lawyer. Since less than 2% of Afghans have access to TVs, community screenings in remote villages have been arranged. Next stop: Kosovo, where **Sesame** will air in November. —*Diana Middleton*



MAD AVE

MY CLIENT, RIGHT OR WRONG

EVER WONDER IF advertising execs have qualms about promoting bogus diet supplements or “safer” cigarettes? If they do, apparently “moral myopia” keeps them silent about ethical quandaries, notes a study of 29 ad agencies. The study says ad execs get so immersed in clients’ corporate culture that this condition leads them to lose their objectivity.

There were encouraging exceptions: Some 20% of the execs said they discussed moral issues with co-workers and clients.

—*David Kiley*

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FACE TIME

CHARLES ARDAI



KNUCKLE SANDWICHES: \$6.99

He knew a genre had gone missing. Pulp fiction. Dime novels. Hard-boiled crime stories. He knew this damn world wasn't the same without it. His gut told him he had to bring it back. His name?

Charles Ardai.

A skinny fella with the look of a mob accountant, Ardai had a plan and a partner, Dorchester Publishing. Come September, Ardai, 35, who co-founded Juno Online Services, would pump out 12 pulp novels over two years, part of his Hard Case Crime series. Dames on the cover and everything.

Six novels would be from new authors, including Ardai writing as... **Richard Aleas.** Six would be reprints of classic writers such as

Erle Stanley Gardner, who helped define pulp's heyday 50 years ago. Ardai figured people would pay \$6.99 a book. Hell, it's a bargain, he told himself. "I want to give people a taste of the old books that will stand up today." Gutsy move, pal. —Tom Lowry



TELECOM TALES

THE CELL IS PLAYING YOUR SONG

YOU KNOW THOSE rrring, rrring, rrring sounds you hear before the friend you've just called answers her cell? Soon they could be history. Instead, you might dial the number and listen to Britney Spears singing *Oops!... I Did It Again* while you wait for your friend to pick up.

Something like that might be your first encounter with a "ringback tone."

Having already signed up thousands of users in cell-phone-mad Asia, this new wireless service could be coming to the U.S. soon. Telcos including **Verizon Wireless, Sprint PCS, and Nextel Communications** are all considering offering the service.

For a monthly subscription fee of only \$2 to \$5—plus, say, \$1 for each song—customers get yet another



way to personalize their phones beyond the already popular ringtones—those melodies phones play in lieu of ringing. Your best friend might buy a new Avril Lavigne ringback, with the lyric "Don't try to tell me what to do" for when her mother calls. And a caller who owes your friend money might hear Liza Minelli's rendition of *Money, Money* from the musical *Cabaret*.

The idea is expected to appeal to teens especially.

The worldwide market for ringbacks is projected to grow from \$148 million last year to \$2.4 billion by 2008, says consultancy **Ovum**.

Ringback tunes can be heard by callers from any kind of telephone—wireless or not. And they don't have to be songs: They can be jokes, clips of celebrity voices, or even advertisements. Of course, for some people that might be a level of torture that rivals voice mail. —Olga Kha

WORKING LIFE

OVERTIME DEBATE On Aug. 23 new rules took effect on overtime eligibility for 115 million U.S. workers. The Bush Administration says the regs give overtime to 1.3 million and strengthen benefits for a further 6.7 million. But critics say that 6 million workers will no longer be eligible. Below are estimates of the numbers in some professions who will see changes:

NOW ELIGIBLE



Teachers
70,000



Sales Workers
82,000

NO LONGER ELIGIBLE



Chefs
130,000



Mortgage Loan Officers
160,000

Data: Labor Dept. Economic Policy Institute

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The Great Innovators

CELEBRATING



As part of its anniversary celebration, BusinessWeek is presenting a series of weekly profiles of the greatest innovators of the past 75 years. Some made their mark in science or technology; others in management, finance, marketing, or government. In late September, 2004, BusinessWeek will publish a special commemorative issue on Innovation.

From Mice To Windows

IT'S HARD, BUT try to imagine—or remember—a world without the Internet, without e-mail, without Microsoft Corp.'s Windows operating system, without pull-down menus in computer programs, and even without the computer mouse. Then, in one fell swoop, one person unveils the underpinnings of them all.

That's what happened in 1968, when Douglas C. Engelbart took the stage at the mid-December Fall Joint Computing Conference in San Francisco. He was nervous, fretting the audience might dismiss his concepts for augmenting human intelligence as too far-out. But he needn't have worried. Over the next 90 minutes he demonstrated how he could edit a document interactively with researchers in a distant location—his laboratory at Stanford Research Institute (now SRI International) in Menlo Park, Calif.—pointing and clicking a boxy mouse to switch among windows on a computer screen. The audience surprised him with a standing ovation. The event is now considered a watershed in the history of computing.

Yet Engelbart says his inventions have been slow to deliver the impact he wanted. Drawing on his experience watching radar images as a technician in the Navy during World War II, he had envisioned window graphics that would make computers easy to use. Then individuals, companies, and governments could tackle major issues collectively. Gradually this would enhance the way people think and learn. Today we have online teamwork and so-called learning organizations. But society has yet to exploit computers to boost human intelligence on the scale that Engelbart has been dreaming about since the 1950s.

With all his inventions now in daily use by millions of people, Engelbart must be a billionaire, right? Hardly. He has picked up some sizable cash awards, including \$500,000 in 1997 when he was honored as an outstanding

**Engelbart's
info-tech
innovations
haven't
changed
society as fast
as he hoped**



inventor by Massachusetts Institute of Technology. But the only bonus he earned from SRI for his 1963 invention of the mouse was \$10,000, years after he left SRI to start the Bootstrap Institute in Fremont, Calif. As was customary in the 1960s, Engelbart assigned all his patent rights to his employer.

Never mind. At 79, as in his youth, Engelbart is driven more by the desire to make humanity smarter, not himself richer. And on this score, he believes there is a long way to go. Engelbart saw his 1968 prototype browser—a combination of what was called groupware and hypertext (the “HT” in HTML, or hypertext mark-up language)—as a two-way tool for sharing

knowledge remotely, spanning distances, language barriers, and other social and cultural divides. His ideas helped spawn a huge marketplace for information technology. Still, he finds the rewards to society disappointing.

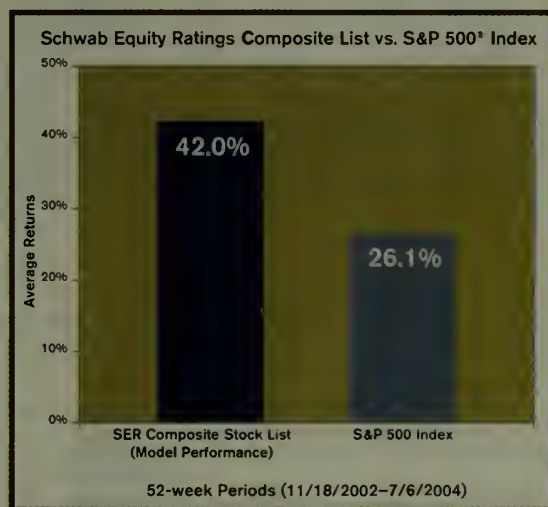
In Engelbart's view, the marketplace may excel at improving products and making them cheaper. But when it comes to coping with critical, global problems such as environmental degradation and access to fresh water, the market doesn't provide the necessary mechanisms and incentives, he says. It's not going to help us “discover the combination of technology and organizational changes that will produce effective solutions.” For that, a higher order of shared intelligence is essential. When computing brings us closer to that plane, Doug Engelbart will be the first to cheer. ■

—By Otis Po

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GEORGE BUSH HAS A POWERFUL ENERGY PROGRAM

WRITER JOHN CAREY'S DESCRIPTION and endorsement of candidate John Kerry's energy plan—and his one-sentence dismissal of President George W. Bush's programs—will sound persuasive to people who don't study the subject ("Kerry's high-wattage energy plan," *News: Analysis & Commentary*, Aug. 9). But even a modest inquiry reveals that it is the President who has been offering a strong, coherent energy plan.

Among Bush's achievements are: Our hydrogen fuel initiative to power vehicles with domestically produced hydrogen instead of relying on foreign oil; our \$1 billion FutureGen program to build an entirely clean-operating coal power plant; our creation of three international partnerships to address global warming with enhanced science and technology; and our regular submissions of energy-efficiency and renewable-energy budgets to Congress.

Meanwhile, [Carey] gushes over such Kerry proposals as his support for ethanol, without mentioning that this is a longstanding Bush position. Senators Kerry and John Edwards, by being absent from the Senate when the energy bill failed by two votes, kept enhanced use of ethanol from becoming law, prevented enlargement of alternative fuel, clean coal, and new energy technologies programs from moving ahead, and killed the extension for wind and other renewable energy tax credits and the energy tax incentives earlier this year. [Kerry] has defended the Kyoto Treaty and a carbon cap that the independent Energy Information Administration said would likely devastate the coal sector, cutting coal use between 18% and 77% and boosting U.S. energy prices between 17% and 83%. It

was disappointing to see a piece so one-sided and unobservant of the facts.

—Spencer Abraham
 Secretary of Energy
 Washington

GETTING U.S. FOREIGN POLICY ON TRACK

IN "FOREIGN POLICY: The pros and cons of John Kerry's approach" (*Editorials*, Aug. 9), an important problem, the settlement of the Israeli-Palestinian conflict, was given its due regarding the fight against terrorism. Not only should settlement of the Israeli-Palestinian conflict be put on the front burner but America should give credence and support to the Geneva Accord. This accord is the product of Israelis and Palestinians who desire security and an eventual peaceful coexistence for both peoples. The international community also supports the positive steps of this accord. Avoiding dealing with this major problem is at the expense of America as well as the Israelis' and Palestinians' welfare. In fact, it threatens world peace. Let's get on with being a honest broker in this Mideast battle.

—Alison Hopp
 Williamsport, Pa.

I HAVE NEVER SEEN the integrity of America's policies deteriorate to such a low level—and the credibility of its leaders so skeptically questioned worldwide—as during the Bush Administration. Senator John Kerry is not offering much better prospect on the Middle East either. When American policies serve narrow interests rather than national interests, everybody suffers. When policies abandon America's solid values of fairness, due process, justice, and self-determination, the world suffers. More important, under such conditions, America

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When it came to our tasting of "white goods," the superpremiums ruled the day. Here, our top three in each category, plus our tasters' comments:

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Readers Report

CORRECTIONS & CLARIFICATIONS

In the Aug. 16 Readers Report letter from Edward M. Syring Jr., we misprinted the median household net worth in the U.S., excluding home equity. It is \$23,200.

loses something far more profound—its moral authority.

—J.E. Jreisat
Tampa

WAS IT ARROGANCE when the U.S. entered Somalia, Panama, and Haiti? Would we have been arrogant if we had entered Rwanda to save thousands of Africans? The U.N. did nothing to stop ethnic cleansing in Bosnia and little in the Sudan. It was the U.S.'s prodding of NATO and supplying nearly all the armament and bombing in Bosnia that stopped the slaughter there. Waiting for others to stop tyrants after September 11 is foolish. The U.N. is probably as ineffective now as the League of Nations was before World War II. The stakes are much bigger now.

—Richard Andrews
Alexandria, Va.

A SHARP EYE ON INVENTORS OF THE LASER

IN "THE LIGHT FANTASTIC" (The Great Innovators, Aug. 2), Adam Aston credits Charles Townes with inventing the laser. He dismisses Gordon Gould merely as one "who later challenged" Townes's laser patent. If read literally, this statement is incorrect. Both gentlemen—as well as others—got separate patents early on. If one distinguishes, as one should, between masers and lasers, then Townes can be said to have invented the former, and Gould the latter. It's a complicated story and the subject of several books.

—Karl F. Jorda
David Rines Professor of Law
Franklin Pierce Law Center
Concord, N.H.

HOW TO AVOID RUINOUS LITIGATION

IF CORPORATIONS got more responsive to complaints and quit stonewalling cases where liability is unambiguous, the cost of litigation would be much smaller, and the portion of this "tax" going into the pockets of customers much greater ("Let's put the 'litigation tax' on trial," Economic Viewpoint, Aug. 9).

A more punitive and regressive "tax" on American business is the "overpaid CEO" tax. It should be noted that this

tax, unlike the litigation tax, can be completely avoided by the corporations' own determination to do so.

—David M. Sanderford
Granbury, Tex.

LIVING HIGH ON \$559 A WEEK?

I AM TROUBLED by the notion that \$559 a week is a "high-wage job" ("Another look at those job numbers," News: Analysis & Commentary, July 26). Arguing that things are "healthy" on the job front because there is growth among the "48% of American workers [who] belong to occupation/industry groups where the median pay is \$559 a week or more" amounts to generalization. Living on \$559 a week is not healthy. Breadwinners on such wages would be shocked to be considered in "high-wage" jobs.

—E.K. Torkornia
Laurel, Md.

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Books

Prelude to Terror

OSAMA The Making of a Terrorist

By Jonathan Randal; Knopf; 339pp; \$26.95

GHOST WARS The Secret History of the CIA, Afghanistan, and bin Laden, from the Soviet Invasion to September 10, 2001

By Steve Coll; Penguin Press; 695pp; \$29.95

Three years after the September 11 attacks, volumes that greatly deepen our understanding of the earth-shaking events are starting to appear. Two of these, Jonathan Randal's *Osama* and Steve Coll's *Ghost Wars*, were begun well before the attacks on America. Both are

well worth the wait.

The two books complement each other. Randal, a retired foreign correspondent for *The Washington Post*, enriches the still-sketchy picture that most of us have of bin Laden and his family. For the first time, in *Osama*, we hear a lot about bin Laden's mother, who, according to some informants, was a concubine and had roots in the Syrian Alawite sect, whose mystical beliefs are considered heretical by many Muslims—including the puritanical Saudis. But corraling such fascinating details isn't Randal's only forte. Better than any previous author, he explains the volatile regional milieu that enabled a minor son of a Saudi contracting potentate to become a hero to many Muslims.

Randal focuses his story on the Arabian peninsula, where bin Laden was born and educated. In contrast, Coll, South Asia bureau chief for the *Post* from 1989 to 1992 and now its managing editor, ranges in his reporting across the Sudan; Afghanistan, where bin Laden found sanctuary; and Pakistan, whose military and intelligence Establishment supported bin Laden's noxious hosts, the Taliban. Coll's narrative benefits from rare access to the handful of CIA agents who were aware of the dangers bin Laden posed in the late 1990s but who lacked the support of their bosses in Washington to act effectively against him. Of course, notes Coll, the no-holds-barred covert war that the CIA and Pakistan sponsored

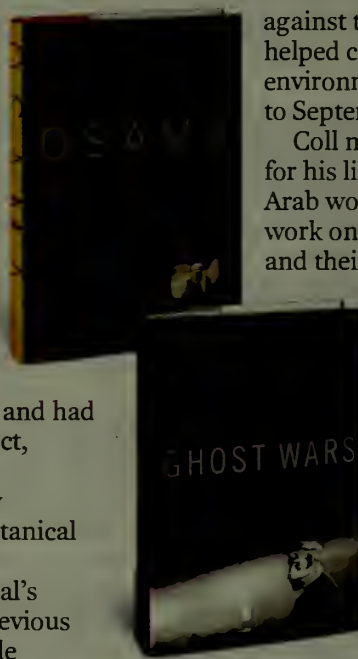
against the Soviets in the 1980s helped create the violent environment that eventually led to September 11.

Coll more than compensates for his limited knowledge of the Arab world with a first-rate work on intelligence operations and their unintended

consequences. If Randal falls short, it is in failing to get inside bin Laden's head to figure out just how he made the leap from religious young man to bloodthirsty militant. But Randal excels at pulling together the strands that may have contributed.

In the West, bin Laden was, prior to September 11, an unknown to all but a small group of cognoscenti. Not so in the Arab world, where deeds such as the near-simultaneous truck bombings of the U.S. embassies in Kenya and Tanzania in 1998 earned him esteem. "In many Muslim eyes those operations had transformed and vaulted him into the exalted status of desert ascetic, Che Guevara, Robin Hood, Saladin, and Avenging Angel of Death rolled into one," Randal writes.

Bin Laden also has a gift for eloquence that Randal compares to that of the charismatic Egyptian President Gamal Abdel Nasser, whose radio speeches aroused revolutionary fervor across the region in the 1950s and '60s. "Osama's low-key, classical Arabic had similar mesmerizing impact on a younger generation," he writes.



It's not clear when or how these skills merged. As a youth, bin Laden seems to have made little impression on many of his acquaintances. A Palestinian engineer who worked with him on one of the family company's road projects figured he was not tough enough to be a leader," writes Randal. Another longtime acquaintance describes him as average plus, not average minus, but just average."

Osama would fool them all, including his billionaire family—owners of the largest Saudi contracting outfit—whose members he manipulated and whose reputation he sullied. Bin Laden was one of 54 children produced by the more than 20 wives of Mohammed bin Laden, an illiterate but savvy and hard-working Yemeni immigrant who persuaded the House of Saud to entrust him with its most sensitive projects—from palaces to roads and air bases.

One enticing subplot is how the House of Saud nurtured a viper in its nest. In the early 1980s, the royal family tapped each prominent clan to nominate a member to a committee raising funds for the *jihād* against the Soviet Union in Afghanistan. The ultrareligious Osama was born for the job, and he also had a talent for self-promotion. He is mostly remembered as doing things far from the front, but he managed to see some action in a battle called Jaji—though his role there seems to have been exaggerated. Still, with the help of the Saudi press, he inflated himself into a war hero. By the late 1980s, Randal writes: "Osama, not yet 30, had turned himself into something of a religious pop star in a land hungering for inspirational role models."

The Al-Saud were slow to figure out that a loose cannon Osama had become. He irritated them by meddling in the affairs of their southern neighbor, Yemen, and alarmed them by repeatedly warning about Saddam Hussein, whom he called an "apostate." When Saddam proved him right by invading Kuwait, Osama used family connections to win an audience with Defense Minister Prince Sultan and pleaded that he could defend the kingdom from Saddam with a crew of Afghan veterans. When the Al-Saud decided that the U.S. military was a better bet, the die was cast. "As it turned out, the Al-Saud never found an

effective way of dealing with Osama," Randal writes. "Nor did anyone else."

That ineffectiveness is the subject of much of Coll's book. Perhaps the best chance of grabbing Osama was during his stay in Sudan, where he moved in 1994. The U.S. was becoming aware of bin Laden's deadly activities. "At a White House briefing early in 1995, CIA analysts described bin Laden's Khartoum headquarters as the Ford Foundation of Sunni Islamic terrorism,"

Coll writes. The Sudanese were probably ready to betray bin Laden in 1996, yet neither the Saudis, who thought him a hot potato, nor the U.S., which lacked enough evidence for an indictment, wanted to take him. Soon he was off to Afghanistan, where he was much harder to nab.

That doesn't mean there wasn't plenty of wasted motion. In 1999 and 2000,

Coll says, George J. Tenet, then CIA director, made getting bin Laden a personal mission. But it wound up an exercise in frustration. All sorts of plans were made to take out bin Laden with snatch operations or drones. But at key junctures, Washington was reluctant to pull the trigger—partly because the military was never sure bin Laden was in the intended target area.

Bin Laden, Randal says, liked to characterize the American military as a paper tiger, but he was soon to discover he was mistaken. The U.S. quickly toppled the Taliban—although without corraling Osama.

But Randal sees a more important American weakness in the nation's efforts to cope with the Islamic world. "The Americans' failing," he says, "was that without colonial experience, they didn't have the trained manpower, the generations of friendships, the easy economic ties, the institutional knowledge, the police files, indeed everything that spelled inspired flair and intuition." The British in their heyday had all these things and yet were ultimately forced to withdraw from Muslim lands. "Colonial and post-colonial 20th-century history was littered with wreckage from the disastrous presence of British, French, and American forces stationed in Muslim lands." None of this augurs well for the U.S., which is more deeply mired in the region than ever before. ■

—By Stanley Reed

Randal tells of Osama's past, while Coll focuses on efforts to track him

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Proactive



BY STEPHEN H. WILDSTROM

The World At Your Fingertips

Whether you call them hybrids or smart phones, wireless handhelds that combine voice calls and data services are a hotbed of innovation. With improved e-mail, Web browsing, and games, they're also starting to win over consumers. The devices are still far from perfect, but they are becoming an attractive way to stay connected while you're on the go.

I tried two new and very different handhelds, the Hewlett-Packard iPAQ h6315 and the Danger Sidekick II, both running on the T-Mobile network, along with a new version of an old favorite, the palmOne Treo 600, on Verizon Wireless.

The main distinction of the iPAQ (\$499 with activation) is that it uses both Wi-Fi networking and the slower but more widely available T-Mobile wireless phone network for data. You buy a monthly plan starting at \$80 covering voice, data, and access to T-Mobile Wi-Fi hotspots. The iPAQ then uses fast Wi-Fi networks wherever available, and otherwise switches seamlessly to the phone-based network. Once I entered the required information for the networks I wanted access to, I could fetch mail or Web pages using Wi-Fi in the office or at home, and the T-Mobile network while on the go. It's simple to set the iPAQ up to use any standard Internet accounts. For corporate e-mail, you may need help from tech support.

THE IPAQ'S MAIN E-MAIL SHORTCOMING is the lack of a keyboard. You can add a mini-keyboard that fits over the lower part of the unit, but the Pocket PC software is not optimized for keyboard use, and you'll find yourself needing three hands—two to type and one for the stylus. Otherwise, you enter text using either character recognition or a tiny on-screen keyboard. The iPAQ also comes up short as an everyday voice phone: Because you have to dial by tapping the screen, and because the device is nearly three inches wide, it's almost impossible to operate with one hand.

The businesslike iPAQ is likely to prove most popular among corporations, many of which have developed custom Pocket PC applications. In contrast, the Sidekick (\$299 with activation) just wants to have fun. It rewards users with easy over-the-air downloads of games and other amusements, a decent built-in camera, and software that can pop up a picture of the caller when the phone rings.

The Sidekick's key selling point is a trick this model shares



**DANGER
SIDEKICK II**

with the original, somewhat clunkier model. Push the upper-right corner of the display, and the whole panel pivots open to reveal a 3¼-inch-wide keyboard—huge by handheld standards. The Sidekick comes with a T-Mobile e-mail account, and it is simple to add standard Internet mail accounts. The device is designed to be held so the display is wider than it is high. This, combined with a service that automatically reformats Web pages for the small display, makes it a much better browser than most other handhelds.

The Sidekick, however, makes an awkward phone. Unless you can select a number by scrolling through contacts, you'll have to open the display to dial a call. I suggest using the Sidekick with a headset or as a speakerphone. Data service costs \$20 a month above any T-Mobile voice plan, or \$29 a month for data only.

The latest Treo 600 (\$450 with activation) has no major new features, but it comes from

Handhelds that deliver —on phone calls, e-mail, and plain fun

Verizon Wireless, whose subscribers have been waiting a year for the carrier to offer the popular phone. Voice and data services were excellent, but the Wireless Sync software for relaying corporate e-mail to the Treo required a difficult setup. Unlimited data service costs \$50 a month above a voice plan.

In past columns, I have noted that the Treo 600 offers mobile buyers the best combination of features and size, and that's still the case. But the competition is getting better. Witness the iPAQ's multi-network abilities, which ought to become a standard feature on all these wireless handhelds. ■

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BY JEFFREY E. GARTEN

Thorny Questions For the Next President

Political conventions and Presidential debates are too driven by opinion polls and sound bites for us to know how well the candidates grasp our long-term challenges. If I could privately ask President Bush and Senator Kerry just three questions about economic policy for the next decade—questions that go beyond their hyped campaign pledges on health care,

deficit reduction, and energy independence—here's what they would be, and here are the answers I would hope to hear.

How are you thinking about the upcoming retirement of the baby-boom generation?

By 2040, the population will be heavily skewed toward the elderly—with 20.3 million people of college age, vs. 77.2 million people over 65. In 1960, there were 5.1 taxpaying workers for every Social Security beneficiary; by 2030, there will be 2. With Social Security benefits escalating, Medicare costs growing twice as fast as the economy, fiscal deficits soaring, and our savings rate plummeting, we are headed for wrenching economic and social tensions.

To get out of this bind, we must eliminate budget deficits to accommodate future spending needs. Every new tax break and spending increase should be offset by a corresponding budget cut, and taxes will have to rise gradually. Social Security solvency will have to be strengthened by some combination of reducing cost-of-living increases, means testing, and upping the legal retirement age.

Reforming Medicare will be infinitely more difficult. Unless major changes are made now, Medicare will overrun our entire federal budget. Those changes include driving down prices by letting government negotiate drug discounts, eliminating waste and exorbitant litigation costs, requiring the well-off to pay more for care than the poor, and reducing selected costly interventions to prolong life in the last few months. The latter absorbs 25% of all Medicare payments.

How important is the rise of China and India to the well-being of U.S. citizens?

Hundreds of millions of young Asian workers will soon be entering the global market. They will be energetic, educated, and paid a fraction of U.S. wages. Whether they build aircraft or design software, millions of Americans will be under assault either from imports or offshoring.

We must enhance the flexibility and skills of our workforce by improving schools at all levels. This means reversing the decline in financial support for higher education among most state governments. We must redirect substantial levels of research from the military to commercial applications to open

the way for more sophisticated jobs. We must ensure the portability of pensions and health care and provide wage insurance against temporary layoffs. And we must push harder for more open markets for our exports.

How will you deal with the economies in the developing world?

Of the earth's 6 billion people, 5 billion live on less than \$1 a day. Three billion are under age 25. Over the past decade, improvement has occurred in the poverty levels for the 50 poorest nations, where health-care delivery systems are collapsing. This is a catastrophe with implications, including an even more heightened terrorist threat, for us all.

The U.S. must do more to mobilize rich countries to help on trade, education, and financial assistance. We must strengthen the World Bank and other institutions. To do that, we must fulfill existing aid commitments—such as providing \$15 billion over five years to combat HIV/AIDS—and go well beyond them. (Consider: Last year's congressional appropriation for Iraq was more than five times U.S. official development aid.) In 2000, the U.S. agreed to support the U.N. Millennium Development Goals for education, health, and food security by 2015. Congress should endorse these targets and create a Cabinet-level department to implement them.

Could we expect such far-reaching responses from our Presidential candidates? I'm skeptical. But even with bold answers, the highly partisan and short-term nature of our government policies still needs to be overcome. Moreover, our politicians would have to unite behind the longer-term national interest as they did right after World War II. That could never happen without a farsighted and truly courageous President to lead them. Right now, I'm worried that neither Bush nor Kerry is up to that challenge. ■

Jeffrey E. Garten is dean of the Yale School of Management (jeffrey.garten@yale.edu).

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issues—and
answers
I'd like
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Ask your doctor if VIAGRA is right for you.

VIAGRA is prescribed to treat erectile dysfunction. We know that no medicine is for everyone. If you use nitrate drugs, often used for chest pain (known as angina), don't take VIAGRA. Taking these drugs together could cause your blood pressure to drop to an unsafe level.

The most common side effects of VIAGRA are headache, facial flushing, and upset stomach. Less common are bluish or blurred vision, or being sensitive to light. These may occur for a brief time. Remember to protect yourself and your partner from sexually transmitted diseases.

Talk with your doctor first. Make sure you are healthy enough to have sex. If you have chest pain, nausea, or other discomforts during sex, seek medical help right away. The same is true if you have an erection that lasts more than 4 hours. Call for help at once.

VIAGRA is covered under most Managed Care Plans.

* For some men, in as quickly as 10 minutes; for most, in under a half hour (statistical significance at 14 minutes). In this study, VIAGRA responders, given 100 mg 2 hours after eating, were timed to see how fast they got an erection that enabled them to have sex. † Data on file. Pfizer Inc., New York, NY

Please see our patient summary of information for VIAGRA (25 mg, 50 mg, 100 mg) tablets on the following page.

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PATIENT SUMMARY OF INFORMATION ABOUT

VIAGRA®

(sildenafil citrate) tablets

This summary contains important information about VIAGRA®. It is not meant to take the place of your doctor's instructions. Read this information carefully before you start taking VIAGRA. Ask your doctor or pharmacist if you do not understand any of this information or if you want to know more about VIAGRA.

This medicine can help many men when it is used as prescribed by their doctors. However, VIAGRA is not for everyone. It is intended for use only by men who have a condition called erectile dysfunction. **VIAGRA must never be used by men who are taking medicines that contain nitrates of any kind, at any time. This includes nitroglycerin.** If you take VIAGRA with any nitrate medicine your blood pressure could suddenly drop to an unsafe or life threatening level.

• What Is VIAGRA?

VIAGRA is a pill used to treat erectile dysfunction (impotence) in men. It can help many men who have erectile dysfunction get and keep an erection when they become sexually excited (stimulated).

You will not get an erection just by taking this medicine. VIAGRA helps a man with erectile dysfunction get an erection only when he is sexually excited.

• How Sex Affects the Body

When a man is sexually excited, the penis rapidly fills with more blood than usual. The penis then expands and hardens. This is called an erection. After the man is done having sex, this extra blood flows out of the penis back into the body. The erection goes away. If an erection lasts for a long time (more than 6 hours), it can permanently damage your penis. You should call a doctor immediately if you ever have a prolonged erection that lasts more than 4 hours.

Some conditions and medicines interfere with this natural erection process. The penis cannot fill with enough blood. The man cannot have an erection. This is called erectile dysfunction if it becomes a frequent problem.

During sex, your heart works harder. Therefore sexual activity may not be advisable for people who have heart problems. Before you start any treatment for erectile dysfunction, ask your doctor if your heart is healthy enough to handle the extra strain of having sex. If you have chest pains, dizziness or nausea during sex, stop having sex and immediately tell your doctor you have had this problem.

• How VIAGRA Works

VIAGRA enables many men with erectile dysfunction to respond to sexual stimulation. When a man is sexually excited, VIAGRA helps the penis fill with enough blood to cause an erection. After sex is over, the erection goes away.

• VIAGRA Is Not for Everyone

As noted above (*How Sex Affects the Body*), ask your doctor if your heart is healthy enough for sexual activity.

If you take any medicines that contain nitrates – either regularly or as needed – you should never take VIAGRA. If you take VIAGRA with any nitrate medicine or recreational drug containing nitrates, your blood pressure could suddenly drop to an unsafe level. You could get dizzy, faint, or even have a heart attack or stroke. Nitrates are found in many prescription medicines that are used to treat angina (chest pain due to heart disease) such as:

- nitroglycerin (sprays, ointments, skin patches or pastes, and tablets that are swallowed or dissolved in the mouth)
- isosorbide mononitrate and isosorbide dinitrate (tablets that are swallowed, chewed, or dissolved in the mouth)

Nitrates are also found in recreational drugs such as amyl nitrate or nitrite ("poppers"). If you are not sure if any of your medicines contain nitrates, or if you do not understand what nitrates are, ask your doctor or pharmacist.

VIAGRA is only for patients with erectile dysfunction. VIAGRA is not for newborns, children, or women. Do not let anyone else take your VIAGRA. VIAGRA must be used only under a doctor's supervision.

• What VIAGRA Does Not Do

- VIAGRA does not cure erectile dysfunction. It is a treatment for erectile dysfunction.
- VIAGRA does not protect you or your partner from getting sexually transmitted diseases, including HIV — the virus that causes AIDS.
- VIAGRA is not a hormone or an aphrodisiac.

• What To Tell Your Doctor Before You Begin VIAGRA

Only your doctor can decide if VIAGRA is right for you. VIAGRA can cause mild, temporary lowering of your blood pressure. You will need to have a thorough medical exam to diagnose your erectile dysfunction and to find out if you can safely take VIAGRA alone or with your other medicines. Your doctor should determine if your heart is healthy enough to handle the extra strain of having sex.

Be sure to tell your doctor if you:

- have ever had any heart problems (e.g., angina, chest pain, heart failure, irregular heart beats, heart attack or narrowing of the aortic valve)
- have ever had a stroke
- have low or high blood pressure
- have a rare inherited eye disease called retinitis pigmentosa
- have ever had any kidney problems
- have ever had any liver problems
- have ever had any blood problems, including sickle cell anemia or leukemia
- are allergic to sildenafil or any of the other ingredients of VIAGRA tablets
- have a deformed penis, Peyronie's disease, or ever had an erection that lasted more than 4 hours
- have stomach ulcers or any types of bleeding problems
- are taking any other medicines

• VIAGRA and Other Medicines

Some medicines can change the way VIAGRA works. Tell your doctor about **any medicines** you are taking. Do not start or stop taking any medicines before checking with your doctor or pharmacist. This includes prescription and nonprescription medicines or remedies:

- Remember, VIAGRA should never be used with medicines that contain nitrates (see *VIAGRA Is Not for Everyone*).
- If you are taking alpha-blocker therapy for the treatment of high blood pressure or prostate problems, you should not take a dose of greater than 25 mg of VIAGRA at the same time (within 4 hours) as you take your dose of alpha-blocker.
- If you are taking a protease inhibitor, your dose may be adjusted (please see *Finding the Right Dose for You*).
- VIAGRA should not be used with any other medical treatments that cause erections. These treatments include pills, medicines that are injected or inserted into the penis, implants or vacuum pumps.

• Finding the Right Dose for You

VIAGRA comes in different doses (25 mg, 50 mg and 100 mg). If you do not get the results you expect, talk with your doctor. You and your doctor can determine the dose that works best for you.

- Do not take more VIAGRA than your doctor prescribes.
- If you think you need a larger dose of VIAGRA, check with your doctor.
- VIAGRA should not be taken more than once a day.

If you are older than age 65, or have serious liver or kidney problems, your doctor may start you at the lowest dose (25 mg) of VIAGRA. If you are taking protease inhibitors, such as for the treatment of HIV, your doctor may recommend a 25 mg dose and may limit you to a maximum single dose of 25 mg of VIAGRA in a 48 hour period. If you are taking alpha-blocker therapy, you should not take a dose of greater than 25 mg of VIAGRA at the same time (within 4 hours) as your dose of alpha-blocker.

• How To Take VIAGRA

Take VIAGRA about one hour before you plan to have sex. Beginning in about 30 minutes and for up to 4 hours, VIAGRA can help you get an erection if you are sexually excited. If you take VIAGRA after a high-fat meal (such as a cheeseburger and french fries), the medicine may take a little longer to start working. VIAGRA can help you get an erection when you are sexually excited. You will not get an erection just by taking the pill.

• Possible Side Effects

Like all medicines, VIAGRA can cause some side effects. These effects are usually mild to moderate and usually don't last longer than a few hours. Some of these side effects are more likely to occur with higher doses. The most common side effects of VIAGRA are headache, flushing of the face, and upset stomach. Less common side effects that may occur are temporary changes in color vision (such as trouble telling the difference between blue and green objects or having a blue color tinge to them), eyes being more sensitive to light, or blurred vision.

In rare instances, men have reported an erection that lasts many hours. You should call a doctor immediately if you ever have an erection that lasts more than 4 hours. If not treated right away, permanent damage to your penis could occur (see *How Sex Affects the Body*).

Heart attack, stroke, irregular heart beats, and death have been reported rarely in men taking VIAGRA. Most, but not all, of these men had heart problems before taking this medicine. It is not possible to determine whether these events were directly related to VIAGRA.

VIAGRA may cause other side effects besides those listed on this sheet. If you want more information or develop any side effects or symptoms you are concerned about, call your doctor.

• Accidental Overdose

In case of accidental overdose, call your doctor right away.

• Storing VIAGRA

Keep VIAGRA out of the reach of children. Keep VIAGRA in its original container. Store at 25°C (77°F); excursions permitted to 15-30°C (59-86°F) [see USP Controlled Room Temperature].

• For More Information on VIAGRA

VIAGRA is a prescription medicine used to treat erectile dysfunction. Only your doctor can decide if it is right for you. This sheet is only a summary. If you have any questions or want more information about VIAGRA, talk with your doctor or pharmacist, visit www.viagra.com, or call 1-888-4VIAGRA.



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September 2002

BY JAMES C. COOPER & KATHLEEN MADIGAN

That Last-Quarter Slowdown Is Old News

Gas prices may have peaked in May—and consumers are spending again

U.S. ECONOMY

The most recent economic news makes it clear that the growth slowdown in the second quarter, highlighted by exceptionally weak consumer spending in June, was not a precursor of future weakness. Yes, the economy is easing back from its speedy 5% pace in the year that ended in the first quarter. But the second-

quarter dip in growth far overstates the downshift.

Despite surging oil prices, a waffling stock market, and some surprisingly weak job numbers, the economy began the third quarter on much firmer ground. In particular, consumers are up and running again, although perhaps at more of a jog than a sprint. And businesses are moving ahead with new outlays for equipment.

In July, retail sales, industrial production, and housing starts all bounced back from their poor June showings, and manufacturers' new orders posted another advance. And in August, consumer sentiment is holding firm. Surveys show that builders are increasingly optimistic, and mortgage applications remain high. In addition, weekly jobless claims through mid-August remained low and, as in recent months, continue to indicate no new weakness in the job markets.

Most important, household spending this quarter is bouncing back. The Commerce Dept.'s tally of retailers showed sales rebounded in July, rising 0.7% from June. Plus, Commerce revised June sales higher. They now show a dip of only 0.5% from May, far less than the 1.1% decline originally reported.

For August, some retailers have noted soft back-to-school sales. But unlike Commerce's data, individual stores compare sales with those from the year before. Since sales in August, 2003, were boosted by \$16 billion in tax-rebate checks, this year's numbers, by comparison, appear weak. Also, Wal-Mart Stores Inc. said Hurricane Charley dampened sales at 200 of its stores, 75 of which had to close for a time. But post-hurricane reconstruction should lift sales, especially for building supplies. So far, the data imply the average level for third-quarter outlays is off to a good start, which will provide growth with a solid foundation.

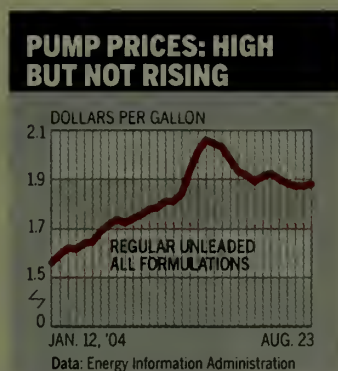
BETTER YET, TAMER INFLATION means that each dollar consumers spend will go toward purchasing more actual goods and services, not just covering higher prices. That's a switch from last quarter, when the energy-led spike in inflation meant the overall rise in prices accounted for 77% of last quarter's increase in the money households spent, the most in more than a decade.

But in July, the consumer price index actually fell 0.1%.

That mainly reflected a 4.2% drop in gasoline, although the moderation in price gains goes beyond energy. The core CPI, which excludes energy and food, rose a slim 0.1% in both June and July. In fact, over the past three months, the annual rate of core inflation has fallen to 1.6%, less than half the 3.3% rate in the three months before that. In the third quarter, slower overall inflation

will allow the buying power of household incomes to stretch further than it did in the second quarter.

Of course, the soaring price of crude oil, which had been hovering in the \$45 to \$50 per barrel range for most of August, has become the biggest wild card in the outlook. But even here there's some room for optimism.



Oil prices on Aug. 25 fell below \$44 per barrel, nearly \$6 below their recent peak. Also, gasoline prices in the spring rose far higher than the price of crude oil would have suggested. So despite higher crude prices since then, prices at the pump may not regain their May peak.

BACK IN MAY AND JUNE, the average retail price for unleaded gasoline jumped to well over \$2 per gallon at a time when crude oil was selling at about \$38 to \$40 per barrel. But based on the historical relationship between the quarterly averages of oil and gas prices from 1985 to 2003, pump prices have typically been about \$1.75 or less when oil prices traded in that range.

In the second quarter, gasoline averaged \$1.96, which has been consistent in the past with crude oil prices averaging more than \$45 per barrel. With oil in August already running close to that level, and with gasoline prices at \$1.88 for the week ended Aug. 23 (chart), pump prices in coming months may rise, but chances are good that the increase will be limited.

Other factors support that outlook. Gasoline markets have turned around sharply since May, when prices

peaked at \$2.06 per gallon, and inventories were very low. That combination sparked fears of even higher pump prices during the summer. Instead, oil refiners, rushing to cash in on higher prices, boosted gas production, and gasoline imports in July were up 13% from previous-year levels. As a result, gasoline inventories have been rebuilt, and prices have declined just as the summer driving season is winding down.

The next potential problem for household energy costs may not come until winter. According to the Energy Information Administration, refiners continued to maximize gas production in July, beyond the period when they would normally shift output to greater production of heating oil. That pattern could put pressure on heating oil inventories this winter.

The price of No. 2 heating oil is already up 38% from a year ago, and households are locking in their fuel contracts for the coming year. Still, fuel prices during the heating season will be determined mainly by the severity of the winter and the path of crude-oil prices in coming months, both of which are anybody's guess.

FOR NOW, AT LEAST, the firmer tone of consumer spending is buoying overall output, while businesses continue to spend greater sums on equipment. New orders for capital equipment, excluding aircraft, rose 0.6% in July, following a 1.4% gain in June. Shipments are in a strong uptrend (chart), even as the backlog of unfilled orders continues to grow.

Demand, especially from businesses, is driving gains in

industrial production. After falling 0.5% in June, output in factories, utilities, and mines rebounded 0.4% in July. That gain was curbed by a drop in utility output, the result of unusually cool weather, and auto plant shutdowns for new-model changeover. Manufacturing output alone increased a healthy 0.6%. Excluding the drop in autos, factory production rose 0.7%.

RIISING OUTLAYS FOR CAPITAL GOODS



weakened in July, production of high-tech equipment so far this year has grown at a 31.5% annual rate.

With industrial output and consumer spending recovering from their June swoons, chances for a rebound in job growth are improving. As important as oil and energy costs are for the outlook in coming months, the future pattern of job gains is even more crucial. Only if employment growth returns to a healthy pace will there be any assurance that the economy can weather surprise from the energy markets this winter. ■

GERMANY

What If the Export Engine Stalls?

THE LATEST NEWS on Germany's economy shows the recovery remains dependent on exports and not enough on domestic spending. But if oil prices remain high, it may be hard to fix that imbalance anytime soon.

Deutsche Bundesbank data on second-quarter real gross domestic product showed that the economy grew 0.5% from the first quarter, confirming earlier estimates. Business investment in equipment and structures fell, while consumer spending rose only 0.1%. The big boost came from exports, the same source of most growth over the past year.

But given the global slowdown, Germany cannot depend on foreign demand to keep its

factories busy. Mostly because of higher oil prices, economists have cut their forecasts for world growth.

According to the consensus view of private economists, Germany is set to grow by 1.6% in 2004, below the 1.8% gain projected for the total euro zone.

The export dependency also is not helping Germany's deficit. Since exporters don't pay sales taxes, their sales increases aren't improving

government revenue tallies. As a result, Federal Statistical Office data show the budget deficit in 2004 is growing faster than it did in 2003, when the gap hit 3.9% of GDP.

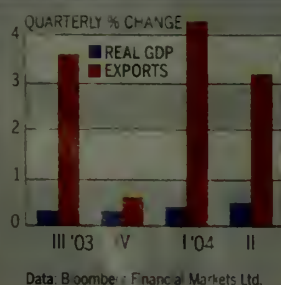
Reviving domestic demand, however, may prove difficult. First, high oil prices are eating into

household budgets. The yearly inflation rate accelerated to 2% in August. Second, hiring has slowed, causing the jobless rate to remain high. Consumer confidence has flattened out at a low level. Plus, hourly compensation last quarter was unchanged from previous-year levels.

The outlook for incomes is dim. In July, carmaker DaimlerChrysler reached an agreement with union IG Metall to limit yearly raises to 1.5%. Now Volkswagen is seeking to freeze the wages of its workforce when it begins union negotiations in September.

The aim is to bring down labor costs while boosting productivity. That will bring needed improvement to the global competitiveness of German companies. The danger is that consumers, burdened with high energy costs and stagnant income, will not generate much internal momentum for the economy. ■

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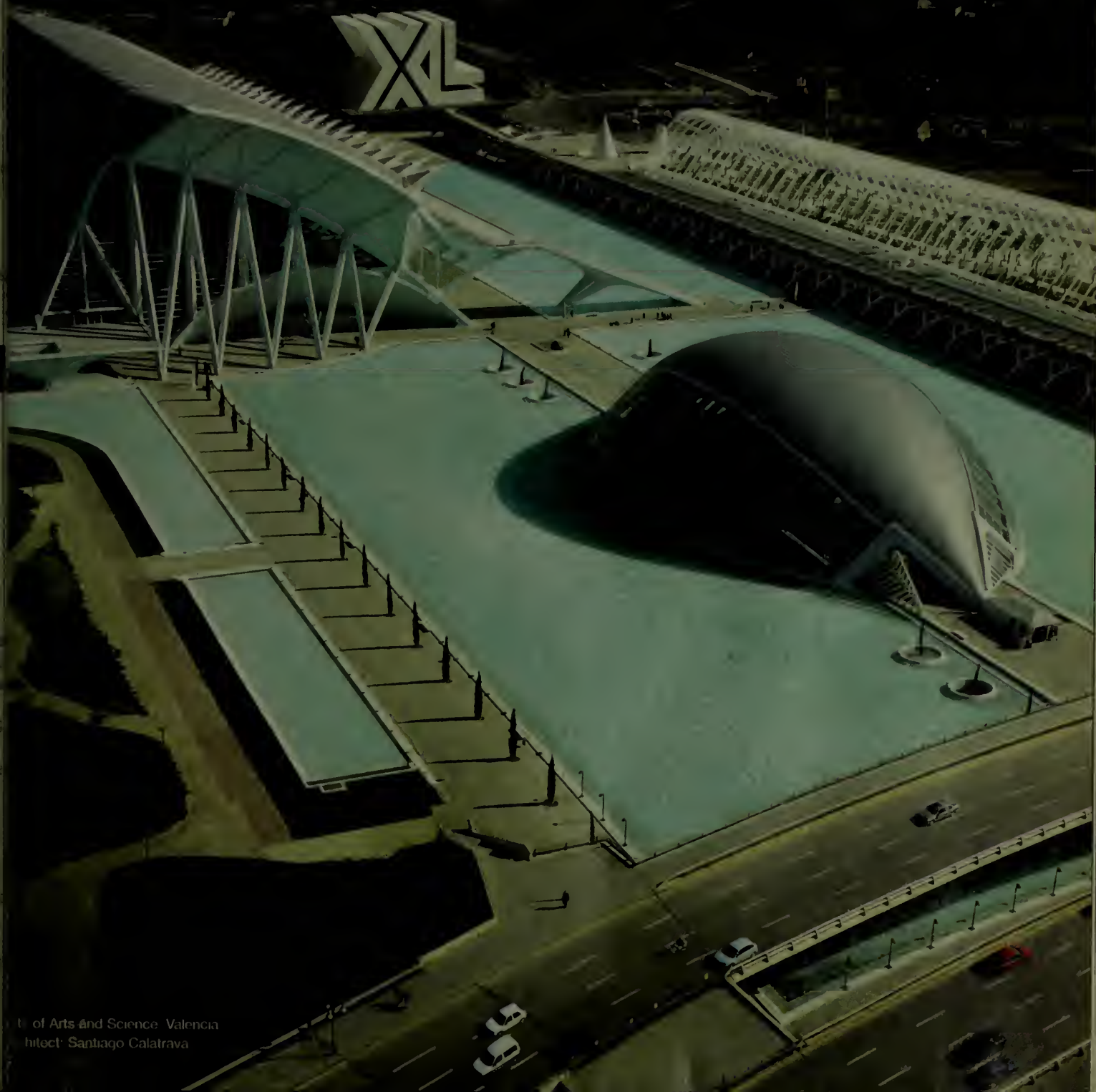
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SELLING THE OWNERSHIP SOCIETY

Like the embattled hero of one of those old Ronald Reagan movies, George W. Bush is a lonely man with a tough road ahead. Facing a challenge from dissolving public support for the troubled U.S. occupation of Iraq and hobbled by an economy that is struggling to create jobs, the President will have to fight to convince voters that he deserves another term in the White House. That battle begins in earnest on Sept. 2 at the Republican Convention in New York City, when Bush will focus attention on his central role in the war on terrorism. Arguing that Iraq is just one phase of a multifront struggle, he will strive to strengthen support for his

proactive foreign policy. But Bush is also a realist. He knows that, no matter how hard he tries, he cannot make Election 2004 revolve solely around terrorism and national security. Even if he wins the debate with Democrat John Kerry over who is seen as stronger and more steadfast, Bush could still come out on the short end Nov. 2 if people think he's not up to the task of managing the economy.

Here, the polls offer little encouragement. In an Aug. 5-10 survey by the Pew Research Center for the People & the Press, 52% of Americans disapproved of Bush's handling of the economy, vs. 42% who approved. Some two-thirds rated an economy that boasts solid growth, benign inflation, and low unemployment as only "fair" or "poor." Why? Scarce jobs, soft wages, and the jolt of higher health and energy costs have created a disconnect between glowing macro indicators and kitchen-table reality (page 50).

Bush needs a shield from Kerry's charges that he's out of touch with the economic pressures buffeting the middle class. In New York, the President will take the wraps off a second-term domes-

tic agenda built around the idea of an "Ownership Society" in which Americans would be empowered to save and invest more, playing a larger role in managing their own health care and retirement finances. By promising to fight for private accounts in Social Security and a simpler and more investor-friendly tax code, Bush will return to the big reform themes that served him well in his 2000 campaign. Given his track record for bold and surprising strokes, he may also use his convention speech to hint at an even more ambitious second-term reform agenda that would tilt the tax balance further away from investment and toward consumption.

SETTING UP A DEBATE

WHILE HARDLY ORIGINAL, Bush's Ownership Society approach is worlds away from the expanded government safety net that Kerry proposes to help strapped workers. The Democrat is making inroads with swing voters by promoting near-universal health coverage, tuition aid, and tax credits for new jobs.

SPELLBOUND The Texan is casting himself as a modernizer



Whatever else it does, Bush's throwing down the gauntlet will open one of the more striking debates of the campaign. That's because there's a philosophical gulf between liberals' evocations of social equity and the comfort of a government helping hand vs. conservatives' paeans to individualism and entrepreneurship. As he barnstorms the country, Bush promotes the virtues of ownership with near-religious fervor, seizing upon one economic number in particular that shines from a so-so record: the torrid pace of home buying. "If you own something, you have a vital stake in the future," the President said in St. Paul, Minn., on Aug. 18.

What's under the ownership umbrella? There's a renewed call, to be voiced in Bush's convention speech, for an aggressive trade-promotion agenda and for private Social Security accounts. The Presi-

PIECE OF THE ROCK VS. THE BIG SAFETY NET

President Bush's Ownership Society stands in sharp contrast to Democrat John Kerry's call for a new middle-class safety net. Here's how Bush's plan differs from Kerry's:

TAXES

BUSH will fight to keep his tax cuts, create new breaks for individual savers, and pledge to reform the tax code. Bush hopes that exempting more savings and investment will boost growth. Critics charge wage-earners will bear more of the tax burden.

KERRY wants to restore rates to the pre-2001 level of 39.6% from today's 35% for those earning \$200,000 or more and would also roll back tax cuts on dividends and capital gains for high earners. The revenues would pay for new health coverage.

RETIREMENT

BUSH will call for Social Security private accounts, insisting that investing part of workers' 12.4% payroll tax in stocks will create higher benefits for many Americans. He would also simplify IRAs and raise savings limits.

KERRY would leave Social Security intact. But he'll consider tax hits and benefit changes that could bolster the system. He also favors porting retirement plans and vows to protect workers' pensions from company cuts.

FLORIDA IS BUSH COUNTRY



dent also will talk up a health system built on individual—rather than employer-provided—insurance.

Bush is saving his biggest ownership flourish for last, however. All year his economists have debated whether the White House can commit to broad reform of the tax code as a second-term goal. Bush has now signed on and will promote the ideas of “pro-growth” reform in his address without dwelling too much on specifics. Says former Council of Economic Advisers Chairman R. Glenn Hubbard, a key architect of Bush’s first-term tax cuts: “The President is a problem-solver. He’s keenly interested in fixing the tax code’s complexity and anti-savings bias.”

In New York, Bush is expected to embrace a major tax initiative, vowing action on three fronts: He will fight to make existing tax cuts permanent; push for new

individual retirement accounts that protect family savings from taxes; and direct the Treasury Dept. to outline changes that make the revenue code “fairer and simpler.” That will trigger a foot-stomping celebration on the floor of Madison Square Garden, since GOP partisans equate those words with “lower and less onerous” rates.

CALMING TAX WORRIES

BUT WHAT IS Bush’s ultimate goal? The steps the President is taking to trim marginal rates and exempt bigger and bigger chunks of investment income are marching the tax code toward a long-time dream of mainstream GOP reformers—retaining the core of the basic income tax while gradually easing the tax bite on savings and investment. Bush must tread cautiously, however, to quell voters’ fears that he aims to throw out the existing tax

code and replace it with a pure flat tax or national sales levy. To calm those worries, he will insist that any changes keep both the home mortgage deduction and the write-off for charitable giving.

Taken together, the Ownership Society themes resonate broadly, White House officials contend. The slogan returns Bush to the “reformer with results” rhetoric of his 2000 campaign. It permits the Texan to cast himself as a modernizer running against a Big Government liberal, as individual investing and exploding homeownership transform society. It fires up the GOP base with appeals for low taxes and property rights. And by turning the Social Security debate into a discussion of investor returns, Bush may lure young voters who have abandoned him. “The idea is to control your affairs through ownership, starting with homeownership and running to health care and retirement,” says Dan Bartlett, White House communications director. “The question is: Do I trust myself more, or the government more?”

By appealing to an optimistic future, Bush hopes to take peoples’ minds off the economy’s not-so-swell recent past. Business leaders, at least, seem in a forgiving mood. Thomas A. James, CEO of St. Petersburg-based Raymond James Financial Inc., says the President deserves “very good, not outstanding” ratings for steering through the downturn. Yet he worries that Bush’s optimism may ring hollow in the Rust Belt. “I admire Bush for sticking with his agenda,” James says. “[But] it may not

HEALTH CARE

BUSH champions Health Savings Accounts that would let families set up advantaged savings accounts to cover out-of-pocket medical costs. He wants high-deductible health insurance policies to cover catastrophic expenses.

KERRY would bolster employer-based insurance by providing subsidies for catastrophic expenses and by helping small business cover all workers. He’d also expand government insurance for low-income workers and their families.

EDUCATION AND JOBS

BUSH would provide \$500 million in new funding for schools and job training. He backs accounts that would let workers choose the training they need in a fast-changing economy. He also seeks aid for high-school math and science education and for inner-city schools.

KERRY proposes tax incentives to prod manufacturers to increase domestic employment. He also wants to set aside \$200 billion to fund No Child Left Behind reforms and expand Head Start. And he backs expanding tuition tax credits to \$2,500 per year.

be enough." Adds Robert E. Switz, CEO of ADC Telecommunications Inc. in Eden Prairie, Minn.: "The guy stepped in after the bubble and overall did a solid job. His tax reductions worked. I rate him a solid B." What keeps Bush from acing his exams? In chorus, execs cite a \$400 billion budget deficit that, war or no war, most think is too big.

Not everyone is convinced that Bush's paeans to property are an answer to future economic challenges. Liberals say that he envisions wrenching changes in the social compact. The thrust of his policies, foes assert, would be to place most of the tax burden on workers, not investors; to offload risk from corporations to individuals; and to undermine a social insurance system dating back to the New Deal. To critics, the Ownership Society is a reworked version of Newt Gingrich's 1994 manifesto—the Conservative Opportunity Society on Botox.

The White House "has come up with a smart way to package principles that have rattled around the Right for generations," says Alan Brinkley, a Columbia University historian. But "millions of Americans can't afford to 'own' their retirement or health care, as Bush wants. They find the whole concept frightening."

Some right-wingers are also underwhelmed by the ownership chat. They complain that Bush has shunned a flat tax, imposed steel quotas, pushed for a new Medicare drug entitlement, and deviated from the conservative script for the sake of political gain. The fancy labeling effort is "all retail politics, no vision," charges supply-side economist Bruce Bartlett, a flat-tax backer. "They said, 'Geez, we've got this hodgepodge of things, we've got to sell them.'"

Despite carping from the Left and Right, Bush is anxious to take his ownership blueprint on the road. After Labor Day, he'll stump hard for his agenda, trying to make the concept accessible to voters by stressing its component parts:

MORE GOLD IN THE GOLDEN YEARS. Under pressure from opposition Democrats and a post-September 11 market dip, Bush backed off his original pledge to create Social Security private accounts. Under the plan, middle-aged and younger workers could divert a few percentage points of their payroll taxes into 401(k)-like investment funds. Bush argued that no matter how financial markets perform, over the long haul this system will beat the 1.5% annual return that today's workers will get from the system.

Still, he never abandoned the belief that workers get a raw deal from tradi-

SO HOW'S BUSH DOING?

APPROVE DISAPPROVE

Do you approve or disapprove of the way George W. Bush is handling the economy?

2001 Feb.	50%	22%
Sept.	47	44
2002 Jan.	60	28
Oct.	49	40
2003 Jan.	47	45
Sept.	43	48
2004 Jan.	47	47
Aug.	42	52

Do you approve or disapprove of the way Bush is handling his job as President?

2001 Feb.	53%	21%
Oct.	84	8
2002 Jan.	80	11
July	67	21
2003 April	74	20
Oct.	50	42
2004 Jan.	58	35
Aug.	46	45

Data: Pew Research Center for The People & the Press
Surveys based on nationwide samples ranging from about 800-1,500 adults in a period of several days

tional Social Security. So he'll dust off the notion on Sept. 2 without providing many fresh details. Bush will, however, assure Americans over 55 that their benefits will not be cut and stress that new accounts will be elective.

The biggest weak spot in Bush's plan is paying for the transition, which economists say could cost at least \$1 trillion. With a big budget deficit, Bush has nothing in the bank for such massive changes—which is why many Republican pols think he will continue to be thwarted. In the meantime, Democrats will surely revive their "senior scare" tactics, charging that Bush is out to destroy the retirement system.

THE PATH LESS TAXING. Bush is playing both defense and offense on taxes. He will demand that Congress retain his previous rate reductions, insisting that low marginal rates and reduced taxes on divi-

dends and capital gains spur growth and productivity. That's a challenge to Kerry. To help pay for his health-care plan, Kerry wants to hike top rates from today's 35% back to the pre-Bush 39.6% and restore higher taxes on capital gains and dividends for upper-income families.

Taking the offensive, Bush will also call for new Retirement Savings Accounts and Lifetime Savings Accounts, vehicles that let individuals stash away \$5,000 a year without ever paying tax on the earnings. These ideas, while not new, are steps toward creeping reform, because they slash taxes on savings and investment. The White House claims its super-savings plans will boost growth. Critics counter that only the well-off can save enough to use the new breaks. And if Bush keeps exempting more forms of income from taxation, liberals fear he'll erode the revenue base just as Uncle Sam has to fund the Baby Boomers' retirement.

Will Bush shatter the conventional wisdom and unveil a sweeping tax plan in the Garden? He has stunned the pundits before, presenting two giant tax cuts that took Washington's breath away.

But 2004 isn't 2000. Bush now is saddled with a giant deficit, is waist-deep in Iraq, and has used up many of his chits with Congress. Advisers say the President isn't really aiming to pull the tax system out by its roots. Instead, he wants to find ways to reduce its bias against savings and investment and make filing simpler.

The bottom line: Bush will charge up his party with general talk of reform while avoiding controversial specifics—and see how much money is in the federal till following the election. That, and the prospects for disengagement from Iraq, will determine how ambitious he can afford to be.

BUSHCARE. The Administration has no desire to match Kerry's call for a \$650 billion plan to expand government and employer insurance coverage. But Bush can't go into the fall empty-handed. So he is pushing health-care "ownership," trying to move toward individual insurance rather than employer-provided coverage—all at a modest government price of less than \$100 billion. Republicans believe that individuals who buy their own coverage will slash costs by spending their health dollars more wisely.

The Bush Rx: Workers who purchase their policies would receive a refundable tax credit, up to \$1,000, to help offset the cost of premiums. A second proposal would offer a tax deduction to people who combine high-deductible policies with new Health Savings Accounts. And to en-



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courage small businesses to cover workers, Bush would let firms join insurance pools that spread risks and lower costs. The President will also try to limit his foe's advantage on the health issue by tarring KerryCare as pseudo-socialized medicine. "We're siding with patients and docs," says Bush campaign manager Ken Mehlman. "Democrats are siding with elites that dictate to people."

PLATOONS OF COMPASSION. Building on his 2001 No Child Left Behind Act, which set national standards for schools, Bush wants to expand reforms to higher grades and junior colleges, stressing basic skills for the workforce of the future.

To help Americans keep up with a changing job market, he backs \$3,000 personal reemployment accounts that can be spent on training and relocation. These vouchers, plus new proposals for more flexible hours, are billed as ways to give workers more control over their lives.

Does all of this add up to a compelling agenda? Republicans are convinced that Bush is on to something big. "This is not the Democrats' 'Two Americas,'" says

GOP consultant David Carney. "It's a positive message that resonates beyond well-to-do-suburbanites to people who aspire to the middle class." As more Americans squirrel away savings, buy homes, and start investing, Republicans sense a gathering demographic wave that could alter politics in the GOP's favor.

Democrats belittle Bush's ownership agenda as warmed-over Hooverism. They charge that, by pushing investors out on a financial high wire without a net, Bush's policies expose millions of Americans to the risk of stock busts, housing bubbles, and fleeing by financial sharpies. "These stale old ideas will do virtually nothing to encourage ownership—and could actually hurt it," asserts Jason Furman, Kerry's top economic adviser.

Thus, in the election, two strains of the American character will collide: risk-taking and pioneering vs. a government safety net protecting citizens from the

Bush will try to tar KerryCare as pseudo-socialized medicine

excesses of capitalism. "Americans are optimistic and aspire to ownership," says Darrell West, a Brown University political scientist: "But pushing the Ownership Society is still risky, because it plays to future aspirations without addressing people's current economic problems."

Over the long term, the ownership concept holds

both power and promise given that it reflects profound changes in the way Americans live. George Bush's problem, though, is that he has a messy short term to traverse. As he tours the country conjuring visions of prosperity, an unanswered question hangs in the air: What if most Americans are too busy struggling to stay above water to give much thought to owning a nice boat? ■

—By Lee Walczak, Richard S. Dunham and Mike McNamee, with Howard Gleckman and Rich Miller, in Washington and bureau reports

A SECOND TERM

Team Econ: Next Up?

President Bush wants to push forward an ambitious economic agenda in his second term that would include broad reform of Social Security and still more changes in the tax code. But to turn it into reality, he'll be relying on a new team that's largely untested in the political arena.

In the 20 months since Bush began replacing his original crew—Treasury Secretary Paul H. O'Neill and economic advisers Lawrence B. Lindsey and R. Glenn Hubbard, the creative but fractious bunch that designed and won major tax cuts in 2001 and 2002—the new econoids have scored points inside the Oval Office by working smoothly together. Yet some critics wonder whether that harmony conceals a lack of creativity and political muscle needed to push through the next chapter of Bush's economic reform.

There's no sign that the President is going to throw overboard any of his current economic advisers. Treasury Secretary John W. Snow, Office of Management & Budget Director Joshua B. Bolten, and Commerce Secretary Donald L. Evans will



IN FLUX Mankiw and Bolten

in all probability stick around. But Washington insiders wouldn't be surprised if Council of Economic Advisers Chairman N. Gregory Mankiw decides he prefers Harvard University and National Economic Council Director Stephen Friedman steps down after tiring of the Washington grind. Former Treasury official Tim Adams, now policy director for the Bush campaign, could take over at the NEC should Friedman leave.

Unlike Bush's original econ-team, no one in this group comes to the table with a

strongly held agenda. Instead, they're likely to work closely with the President's political advisers to transform his goals for Social Security and tax reform into concrete plans. The most influential player may be Bolten, who has developed a tight working relationship with Bush dating back to the 2000 campaign. He's a major advocate for reforming taxes and adding private investment accounts to Social Security. And as head of the OMB, he also manages the pursestrings.

Snow has forged strong links with Evans, and together the two have been the public face of the economic crew. Snow's main job will be to sell Bush's tax ideas to wary lawmakers and Wall Street. Evans, a longtime Bush confidante, serves as a sounding board and will continue to be a key conduit to the business community.

So far, Bush's economic team has enjoyed easy sailing. But can it carry through the President's aggressive agenda while keeping his pledge to cut a \$400 billion budget deficit in half by the end of his second term? That challenge will put their harmony—and Bush's faith in this group—to the test.

—By Rich Miller and Howard Gleckman in Washington

BusinessWeek online For a Q&A with Office of Management & Budget Director Joshua Bolten, go to businessweek.com/magazine/extra.htm

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COVER STORY

JUST WHO'S IN THE 'INVESTOR CLASS'?

A third of the country, and growing. No wonder Bush is wooing them so ardently

THE TERM "INVESTOR CLASS" used to conjure up images of full-bellied capitalists in corner offices. But the modern reality is that investors are everywhere. In 1980, less than 6% of Americans owned mutual funds. Now 69.2% of American families own their homes, and most people have other investments, too, from stocks to 401(k)s. A third of voters identify themselves as investors.

The Investor Class soared during the '90s boom when everybody from dot-com millionaires to cabbies in turbans was talking about their stocks. But even since the bust, its numbers continue to cut across income and education lines.

Republicans see opportunity in this growing bloc. "With \$5,000 in stock, you become 18% more Republican," declares Grover Norquist of Americans for Tax Reform. No wonder President Bush has begun to roll out an Ownership Society agenda.

The very diversity that marks the Investor Class makes it hard to generalize about its political leanings. But these five investors in many ways typify the segments they represent.

—By Richard S. Dunham in Washington and Ann Therese Palmer in Chicago

UPWARDLY MOBILE



Duane Ewing, like many investors, thinks taxes are too high. "Our overall tax burden is out of control," says the Houston-based personal financial adviser. "The reduction of the capital-gains tax was a good start, but more needs to be done."

Talk like that is music to the ears of White House political guru Karl Rove because Ewing is an African American voter. Polls show that black investors—many of whom, like Ewing, have moved to the suburbs in search of better schools and safer streets—are more open to Republicans than African Americans who don't own a piece of the American Dream.

Ewing, 44, considers himself a Democratic-leaning independent. And while he likes the President personally, he says: "Although [Bush] initially campaigned as a compassionate conservative, he has turned out to be more conservative than compassionate."

Ewing, who has an economics degree from Oberlin and a master's in management from Carnegie Mellon, thinks John Kerry "would try to do more for the middle class," but notes that "the Bush tax cuts were good for me." He worries that Kerry would raise his taxes and is "somewhat disappointed with both choices."

Since he, his wife, Sylvia, and two kids moved to suburban Katy in 2001, they have seen their home increase in value by \$80,000 even though their portfolio of stocks and mutual funds has had its ups and downs. "At best I'm even" during the Bush years, Ewing says, "definitely not better off."

THE MINORITY INVESTOR

- Largely black, urban, and male.
- 6% of electorate, 18% of Investor Class.
- Favor Kerry over Bush, 64%-27%.
- 59% college grads. 60% make over \$50,000 a year.
- Only 35% say country is headed in the right direction.

MIDDLE CLASS WITH KIDS



Peter S. Blasi came face to face with the realities of the Ownership Society 14 months ago with the birth of his daughter, Marie. Blasi, 30, an insurance lawyer, and his wife, Tami, a pediatric oncology nurse, had recently bought a home in Oakville, Mo., outside of St. Louis. That burden and Marie's arrival forced them to think about saving for their daughter's education and their own far-off retirements. "Maxing out on my 401(k) is critical, because, if I don't, I don't know where

the money is going to come from," Blasi says.

With their 401(k)s, bonds, and CDs, the Blasies have joined the largest group of investors: married parents with children at home. Primarily suburbanites, they comprise nearly one-third of investors and 10% of voters. Politically, they tilt heavily Republican, and the GOP is hoping they will become the core of a future majority coalition.

Blasi strongly endorses the President's Ownership Society emphasis. "Changing the federal government's role from bureaucratic Big Brother to allowing citizens to make personal choices with their money and investments is what middle-class families are now demanding," he says.

"Democrats villainize business for political gain," Blasi complains. Blasi, an Independent, is open to supporting the right kind of Dem, but says that unless the party drops its populist rhetoric, it's unlikely that it will get his vote or those of too many other pops with stocks.

THE MARRIED INVESTOR

- Typically 30- to 50-year-old couples saving for kids' education and retirement.
- 10% of electorate, 29% of Investor Class.
- Prefer Bush to Kerry, 53%-39%.
- 66% college graduates. 61% make over \$75,000 a year.
- 63% view Bush favorably.

ON A FIXED INCOME



Pat Consolmagno, 82, is grateful that she and her husband, Joe, have a host of investments and an Englewood (Fla.) home that has more than tripled in value in 25 years. But even with an income of nearly \$80,000 a year from mutual funds, stocks, savings account interest, Joe's DaimlerChrysler pension, and Social Security, they feel the pinch of rising costs for groceries, gasoline, prescription drugs, and local taxes. "I buy what's necessary, not beyond that," the former home economics teacher says.

Consolmagno is particularly pleased about the tax cuts and dividend tax relief delivered by President Bush and the Republican Congress. "Kerry claims the [Bush] tax cut only helped the rich, but we're not rich and it helped us tremendously," the grandmother of three says.

Consolmagno is a strong Republican, like the majority of elderly investors (49%-33%), and a big fan of Bush. Seniors without stock portfolios are much more dependent on Social Security and lean heavily Democratic (47%-34%). No other demographic group has as big a political gap between investors and non-investors as the over-65 crowd.

But some GOP initiatives designed to appeal to AARP voters—like partial privatization of Social Security—leave Consolmagno uneasy. "Don't mess with Social Security," she says. "I can't see it secure when you want to let people invest in their own accounts." And she adds: "I also don't want to control my own Medicare account. [The current system] works fine."

THE SENIOR INVESTOR

- Mostly retired, relying on investments for majority of income. Concentrated in Sunbelt states from Florida to Arizona.
- 6% of electorate, 19% of Investor Class.
- Support Bush over Kerry, 54%-36%.
- 50% make over \$50,000 a year.
- 61% view Bush favorably.

URBAN PROFESSIONAL



Scott Berrie, 38, considers himself a part of the Investor Class but is far more concerned about social justice and foreign policy than tax cuts and investment incentives.

"The Ownership Society is a nice concept, but it's not as important as raising the welfare of the general population," says the CEO of Scojo Vision LLC, a New York eyeglass wholesaler.

Berrie and his wife have two young children, with a third on the way. They own a Manhattan co-op, municipal bonds, Treasury bills, investments in private equity companies, and a 401(k). And like most urban professional investors, they tilt Democratic. Berrie recites a litany of grievances about Bush, from foreign policy bravado to fiscal irresponsibility. "He's stubborn, inarticulate, and doesn't inspire me in the least," he says. "I don't think most Republicans are pawns of wealthy corporate interests, but I believe Bush is."

A particular sore subject is Bush's conservative social agenda. "Stem cell research is a big issue for me. My father died of complications as a result of diabetes," he explains. "I hate to see it hamstrung by the President's pandering to right-wing groups."

Berrie sees Bush-style unilateralism as a tax on U.S. business and a drain on the Treasury. Kerry, he believes, would repair relations with key trading partners. "I'm not a big fan of the EU or France," says Berrie. "Part of me says we don't need them, but the truth is we do. We live in a global economy. The President has to bring people together, not pull them apart."

THE UPSCALE URBAN INVESTOR

- Highly educated, high-income, live in big cities. Economically conservative, socially liberal.
- 6% of electorate, 17% of Investor Class.
- Favor Kerry over Bush, 53%-40%.
- 61% make over \$75,000 a year.
- Just 40% say Bush deserves reelection.

BLUE COLLAR



Janet Zeestraten is not your stereotypical investor. She doesn't have a stock portfolio, T-bills, or bonds, and she has just a high school diploma. But the 50-year-old United Auto Worker from Hugo, Minn., has her own slice of the Ownership Society pie: a rapidly appreciating two-bedroom house 34 miles north of St. Paul and a vacation cabin in Sturgeon Lake. She also has a company-run 401(k) through her job as a final assembly inspector at Ford Motor Co.'s Twin Cities Assembly Plant.

Although she's not an active investor, Zeestraten is favorably disposed to Administration proposals to give her greater choice in medical care and retirement savings. "I like the idea of me having more control over everything," she says. Zeestraten, a mother of five grown children who works the 5 p.m.-to-3:30 a.m. shift with her husband, also is receptive to Republican calls for tax cuts.

But while she's never met a tax cut she dislikes, she's suspicious of GOP motives. "Republicans always take from the poor and give to the rich," she asserts. She also worries about softness in the economy. "When the economy is strong, we work 50 hours a week plus Saturdays," says Zeestraten, a union member for 21 years. "I haven't worked that much since the late 1990s."

Kerry, however, hasn't won her over yet. "I don't like the man," she says. "I think his wife's money goes to his head. I don't like what Bush has done, but I don't know if Kerry would do any better."

THE UNION INVESTOR

- Two-thirds live in states carried by Democrat Al Gore in 2000.
- 7% of electorate, 20% of Investor Class.
- Favor Kerry over Bush, 52%-37%.
- 50% have graduated from college. 71% make over \$50,000 a year.
- 65% have favorable impression of Kerry.

COVER STORY

'WE'RE GOING TO COME THROUGH THIS FINE'

Treasury Secretary John Snow sees a very strong underlying U.S. economy



SINCE FEBRUARY, 2003, Treasury Secretary **JOHN W. SNOW** has been the Bush Administration's No. 1 economic spokesman. The former chief executive officer of CSX Corp. brings a businessman's straightforward approach to questions of taxes, the budget, and economic policy. On Aug. 23, the Secretary talked about those issues with Deputy Washington Bureau Chief Mike McNamee, Senior Writer Rich Miller, and Senior Correspondent Howard Gleckman. Here are some excerpts:

Why is the time right for the sorts of reforms President Bush seeks to promote with his Ownership Society idea?

Twenty-five years ago, only a few people owned stock. Today, 50% of Americans have some equity ownership. That's a healthy thing—to have people get the benefit of returns to capital as well as returns to labor. The President's core idea is: Give people more control over their own lives, empower them to take greater responsibility for their own retire-

ments, health care, and economic security.

In 2001, a Presidential commission offered three methods to replace part of Social Security with private retirement accounts. Does the President favor one?

The Commission showed that personal accounts have a critically important role to play [in making Social Security solvent]. We didn't choose among the three, nor do we endorse any one as the answer. The President wants to get a broad na-

tional dialogue going on securing the future of Social Security. Stay tuned. Social Security will continue to be a major issue on the President's mind.

John Kerry has said that he would keep today's Social Security system and that the President's approach is risky.

We'd give people choices. People are intelligent in the U.S.; they can make intelligent trade-offs. Personal accounts are consistent with the President's Ownership Society, where people take more responsibility for their own lives, for their health care, for their savings. And they'd have something. They get a stake in America.

The President recently said that a national sales tax was an interesting idea. Is the Treasury studying that?

No, not especially.

Are the President's initiatives—retirement savings accounts and lifetime savings accounts—moving us away from taxing income toward taxing consumption?

They're very much part of the Bush Administration's tax agenda. I see them as important initiatives aimed at advancing better tax policy rather than some grand plan. We need to encourage more saving in the U.S. That plays into long-term growth rates because if you invest more for the future, you have higher real wages, higher per capita income, higher prosperity.

The International Monetary Fund wants the U.S. to move faster to cut the budget deficit, which now stands at 3.8% of gross domestic product. Your response?

We're in the process of doing it. At the pace we're at right now, we'll have it cut in a few years to a level that is well below our historic average. Our historic average is something like 2.2% [of GDP]. We're going to have it down to 1.5%, 1.6% in four years' time. We're making very good progress.

But your budget estimates don't include the Iraq war or the \$500 billion cost of fixing the alternative minimum tax.

What we've said is the President's commitment is absolute. Whatever we do has to be done in the framework of the President's commitment to cut the deficit in half. Any fix on the AMT—with everything else that's happening on the expenditure and revenue side—will have to fit within the President's commitment.

The President has been talking about tax

All supply chains are not created equal. Some hold companies back. Others propel them forward.

UPS can help synchronize your supply chain from beginning to end. Enabling goods, information and funds to move exactly where and when they are needed.

The result? Your operation becomes more efficient, your speed to market improves and your customers are happier.

We've helped consumer goods companies rethink the way components are sourced and assembled, cutting weeks out of the production cycle. For high tech manufacturers, we've developed post-sales services to reduce customers' downtime and transform returns and refurbishment into an area of profitability. We've also helped healthcare companies by creating an order-to-cash solution that integrates customer care and accounting with distribution.

Some companies may see a supply ball-and-chain. We, on the other hand, see another success story waiting to happen.

WHAT CAN BROWN DO FOR YOU?



We can make the difference
between supply chain
and supply ball-and-chain.

simplification. Does that mean getting rid of the Internal Revenue Service?

I travel around the country, and there's a common sentiment—the tax code is too doggone complicated. What we mean is making it less burdensome on people to do their taxes. We have made some progress. More and more people are using the EZ form. Far more people are filing electronically. We want to move well beyond that. Whatever you do, there is going to be some tax collector. You are never going to go to a self-enforcing tax system.

How worrisome is the economy's recent softness?

We're going to come through this fine. Economies don't usually move month to month in a constant direction up or down. But the underlying economy remains very strong. Inflation is very low. Productivity is very high. Profitability is high. Cash flow in businesses is high. Monetary policy and fiscal policy continue to work together to accommodate growth. Even if second-quarter [GDP growth] comes in at 3%, with 4.5% for the first, that is well above the historic norm.

The employment numbers for the month of July are a little curious. You've got everything surrounding the payroll number—hours worked and compensation going up, initial claims going down, and the household survey producing 629,000 or so new jobs. Then there's this curious lower number coming out of the payroll survey. My own hunch here is that the real number is somewhere in the middle. We are seeing a lot of jobs—11 straight months of job creation.

Will high oil prices hold the economy back?

Right now, energy prices are an added burden on the American economy—headwinds blowing against an otherwise very strong economy. Those prices are too high. I don't think they're sustainable, because they've gotten out of line with economic fundamentals. Gasoline prices have moderated. I think they'll stay moderate because we're now getting out of the summer driving season. But even in the face of these unwelcome and unsustainably high energy prices, we're continuing to make real good progress. ■

BusinessWeek For a longer Q&A with Treasury Secretary Snow, go to businessweek.com/magazine/extra.htm



FORD PLANT One change is the loss of factory jobs

COMMENTARY

BY MICHAEL J. MANDEL

The Economy: Advantage Bush?

Clinton won reelection in '96 with similar conditions

AS PRESIDENT George W. Bush gears up for his reelection bid, is the economic glass half empty or half full? Certainly it's easy for political partisans to put either a negative or positive spin on the latest statistics. There are 1.1 million fewer jobs than there were at the beginning of 2001, when Bush took office. But gross domestic product growth is running at a 4.8% rate, productivity growth is strong, and compared with the long-term economic drag that most forecasters expected after the terrorist attacks and the stock market plunge, today's economic environment looks positively rosy.

Perhaps a better, and more informative, comparison is with 1996, the last time an incumbent President ran for reelection. Like this one, the

election of 1996, which pitted Bill Clinton against Bob Dole, came several years into a recovery. And the 1996 campaign, like today's, was fought against a backdrop of middle-class anxiety over job cuts and outsourcing, at least in its early stages.

The good news for Bush: On many of the key variables that voters care about the economy looks uncannily like it did in the summer of 1996, a year when the incumbent was reelected. July's unemployment rate was 5.5%, exactly what it was in July, 1996. Similarly, consumer inflation is running at 3%, the same as July, 1996.

Consumer confidence, housing affordability, unemployment claims—all are roughly at 1996 levels.

Which isn't to say that the economy is identical to where it was eight years ago, of course. Some factors have improved considerably this time around: GDP growth, for one, is much stronger. In other areas the economy is worse off, particularly in the number of

Inflation and the jobless rate are exactly as they were

Ring.
Ring.
Ring.

Telefonica needed to keep its telecom network operating
at maximum reliability across Peru's 1.28 million square kilometers.
Who did Telefonica go to for help?

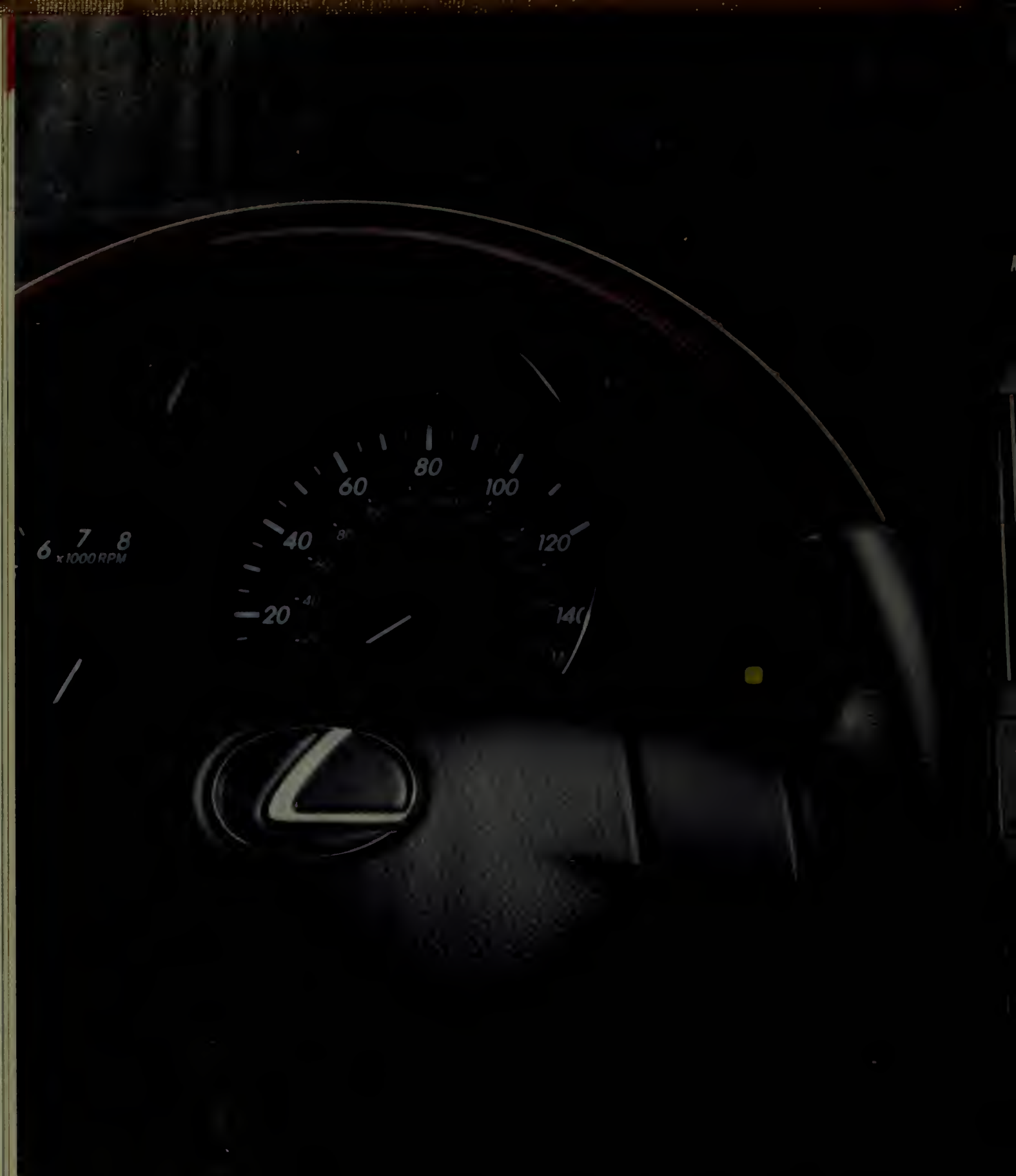


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It's a simple fact that you can't react to what you can't see. The backup camera system, offered in our three Luxury Utility Vehicles and the RZ, was designed to help you see what your mirrors alone cannot. Using a tiny lens at the rear of the vehicle, it transmits a wide-angle view of the area behind you to the rearview mirror or the NAV screen. It's yet one more example of how our pursuit of perfection can better equip you for the road ahead—even when that road is behind you.

LEXUS THE PASSIONATE PURSUIT OF PERFECTION.

ACCORDING TO YOUR REARVIEW MIRROR, SHE ISN'T BEHIND YOU.





UNITED PILOTS
UAL workers
may face big
benefits cuts

BENEFITS

PENSIONS ON A PRECIPICE

Here's what could happen if UAL offloads its retirement plan on the feds

THE THREAT BY UAL CORP., parent of struggling United Airlines Inc., to walk away from its four pension plans has set off shock waves throughout the airline industry. Thousands of pilots, flight attendants, and mechanics are sweating possible drastic reductions in their retirement benefits. And if UAL were to make such a move, other ailing old-line carriers such as Delta Air Lines, Northwest Airlines, and US Airways Group might also slash pension costs to remain competitive. Yet UAL's crisis could spread well beyond airlines. Already it has renewed worries about the shaky financial health of the quasi-governmental agency that insures old-fashioned "defined benefit" pensions for 44 million Americans, the Pension Benefit Guaranty Corp. With the PBGC already \$10 billion short of what it needs long-term to pay promised benefits, some experts fear the situation eventually may require a multibillion-dollar taxpayer bailout.

Here's a primer on what could happen if United or other airlines dump their underfunded pension plans on the PBGC.

Can UAL simply stop making payments on its pension plans?

That's a matter of contention. UAL, which is seeking new financing to emerge from bankruptcy protection, missed a July payment of \$72 million owed to three of its plans and says it will skip more than \$500 million in payments due in September and October. A bankruptcy court judge so far has not ruled on the PBGC's request that UAL make the payments, which are required under federal pension law. But UAL is under intense pressure to pony up. Treasury Secretary John Snow, who sits on PBGC's board, told *BusinessWeek* on Aug. 23 that he agrees that UAL must pay. Says Snow: "There are binding obligations, and they have to be taken seriously."

How would a pension dump work?

To offload its pensions onto PBGC, United would have to prove it is under severe financial distress. That shouldn't be hard, since the carrier has been in Chapter 11 since 2002, and its financial condition remains weak. The PBGC would assume the assets and liabilities of the plans, which the insurer estimates are underfunded to the tune of \$8.3 billion. That would be the largest corporate pension default ever, far surpassing the \$3.6 billion that Bethlehem Steel Corp. saddled the agency with in 2002. PBGC could petition

for more of UAL's assets, but it would fall in line behind many other creditors.

What would United's workers and retirees get?

Collectively, \$1.9 billion less than they expect now, since the PBGC would cover only \$6.4 billion of the underfunding. That's because the PBGC's payments to retirees are capped by law at \$44,386. And that maximum annual payout is far less than most pilots and some attendants and mechanics have been promised. Pilots face a double hit: Not only are they big earners, but by law they must retire at 60. Yet the PBGC reduces its payouts for those who retire before age 65. That means a 60-year-old senior pilot at United, who could expect a yearly pension of \$100,000, would receive just \$28,500. Little wonder that some pilots at United and other older carriers who can take lump-sum pension payouts if they retire now, are calling it quits.

Would other carriers follow United's lead?

Very likely. If United can offload its pensions, it would add hundreds of millions in annual cash flow. That would enable it to boost spending on facilities and planes, and lower fares to compete with upstart carriers that don't offer traditional pension plans. Such a move would give UAL a huge edge, thus compelling Delta and US Airways to do the same, says Roger E. King, senior analyst at CreditSights Ltd., an independent debt research firm.

But handing pension plans over to the PBGC would essentially require airlines to file for Chapter 11, an unappealing step. That's why Standard & Poor's credit analyst Philip A. Baggeley thinks it's more likely that UAL's old-line rivals would use United's pension termination as a cattle prod to win big concessions from pilots and other employees. From their perspective, "even if concessions are bad, bankruptcy is far worse," says Baggeley.

So would ditching pension plans help the airline industry restructure?

Knocking out costly pensions alone won't offset the traditional carriers' triple whammy of the post-September 11 travel drop-off, high fuel prices, and the proliferation of low-cost carriers. And terminating plans can be a two-edged sword. "There is always the danger that the unionized workers who lose their pensions will want some sort of quid pro quo—reduced pro-

Could taxpayers wind up paying for a bailout of the PBGC?

ductivity or more flexible work hours," says Stuart Klaskin of aviation consulting firm Klaskin, Kushner & Co. in Miami.

Consider the fate of US Airways. The carrier looked like it might pull out of its tailspin 17 months ago, when it filed for Chapter 11 and dumped its pilots' pension plan, underfunded to the tune of \$600 million, on

the PBGC. But today it is again fighting off bankruptcy. At best, shedding pension plans would let the legacy carriers muddle along—without sharply reducing bloated costs or eliminating the problem of too many carriers chasing too few passengers.

Can the PBGC withstand a raft of pension offloads from the airline industry?

In the short term, yes. The agency has \$40 billion in assets and would inherit billions more up front from the carriers' plans to cover liabilities that would be paid out over decades.

Still, a funding crisis looms. Already, the

line pension terminations would juice the agency's campaign on Capitol Hill to switch to risk-based fees keyed to a company's credit rating and the funding level of its plan. Currently, the agency gets most of its premium revenue from a \$19 annual charge for every worker whose pension is insured. The PBGC "is unable to control its own destiny" because it doesn't set its own premiums or control who it insures, says Steven A. Kandarian, PBGC's former executive director.

But lawmakers and businesses are likely to balk. "Risk-based premiums put the higher burden on those who can afford it least," says Baruch A. Fellner, a partner at Gibson, Dunn & Crutcher and former PBGC associate general counsel. And raising premiums for all would penalize companies that have continued to fund plans. General Motors Corp. floated a \$14.5 billion debt offering last year to shore up its \$19 billion pension shortfall. Higher premiums on top of that would be unfair, says GM Chairman G. Richard Wagoner Jr.: "It falls into the 'no good deed goes unpunished' category."

The danger is that companies that

have played by the rules get fed up and switch to 401(k) plans. Workers would get the retirement benefits they've accrued—but no new ones.

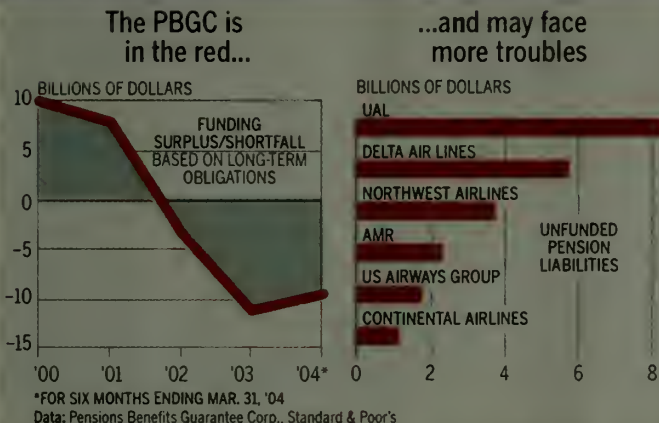
So what's the likely outcome?

Closing loopholes that let weak companies avoid making pension contributions would help to deter companies from overpromising

benefits. So would raising the cap on tax-deductible contributions so companies could stash more in their plans in good times. But such reforms, which require congressional approval, may not come soon enough. Many experts think taxpayers will end up footing the bill for a PBGC bailout. "Unless PBGC gets lucky, this will be the next savings and loan scandal," says Kent Smetters, associate professor of insurance and risk management at the University of Pennsylvania's Wharton School. Except in this case, no one can say they didn't see it coming. ■

—By Amy Borrus, with Lorraine Woellert, in Washington; with Nanette Byrnes in New York and Joseph Weber and Brian Grow in Chicago

UNDER STRESS



PBGC is paying out \$3 billion in benefits annually and taking in barely \$1 billion in premiums. Investment income doesn't cover the gap. A string of corporate bankruptcies, many in the steel industry, have already hammered the agency. And the PBGC's premium base is shrinking as more employers switch from their insured traditional pensions to uninsured 401(k) plans, where employees bear the risk of making sure they save enough for retirement. Since the mid-1980s, in fact, the number of traditional defined-benefit plans has plunged by more than 72%.

Can the PBGC's finances be propped up?

Not easily. It takes an act of Congress to raise the PBGC's premiums. A spate of air-

COMPUTERS

DELL OUTFOXES ITS RIVALS

But a new focus on PC margins may take heat off the competition

AUG. 12 COULDN'T HAVE played out more differently for PC giants Hewlett-Packard Co. and Dell Inc. Early that day, HP stunned the market by missing quarterly earnings estimates and lowering its outlook for the rest of the year. Later that day, Dell hit its profit targets and delivered a sunny forecast for the quarter.

Dell has outfoxed HP before, but this time it's using different tactics. After three years of slashing prices to grab PC market share, Dell is backing away from the industry's bloodiest price wars in a bid to goose its profits. Since July, the company has raised prices as much as 13% on some desktops, including its low-end ones, and held pricing firm on most others, according to researcher Current Analysis Inc.

If Dell stays the course, could this mark a significant shift in PC pricing after years of downward pressure? Most experts say that's unlikely since Dell's rivals are locked in a brutal battle at the bottom of the market and in no position to raise prices. Budget-price PCs, says Chuck May, vice-president of desktops for Gateway, "are critical for driving sales."

But whatever its rivals do, Dell's shift is already helping the bottom line. While raising prices has slowed sales growth—second-quarter unit shipments were up just 19%, the slowest rate in more than a year—revenues rose 20%, to \$11.7 billion, while net income soared to \$799 million.

Those meatier profits are helping to separate

Dell from the pack even as worries about the strength of the tech spending recovery mount. On Aug. 25, the Commerce Dept. reported that new orders for PCs and related products fell 6.7% in July. As a result, the rest of the industry likely will keep chasing low-end sales to keep volumes high. "Dell doesn't wait around as long as its competitors when there's weakness in a market," says First Albany Capital Inc. analyst Joel Wagonfeld.

TACTICAL SHIFT

DELL HAS PROMISED 15% annual revenue growth over the next few years so its stepped-up focus on profits is not without risk. As it moves away from the bottom of the market, it will have to ensure it replaces those sales with other products, including servers, printers, and data storage gear. So far, it's working: Sure, profits from consumer sales in the U.S., which account for 13% of revenues, fell 3% in the second quarter. But earnings from sales of more profitable equipment to businesses, which bring in 55% of revenues overall, grew 20%.

Why the tactical shift? Dell Chief Executive Kevin B. Rollins began to fret when gross margins fell slightly, to 18%, from 18.2% in the fiscal first quarter. Dell was pricing too aggressively, he says, given that costs of key components such as memory chips and flat-panel displays were spiking. "In that environment," he told *BusinessWeek*,

"you get a bit of a margin squeeze."

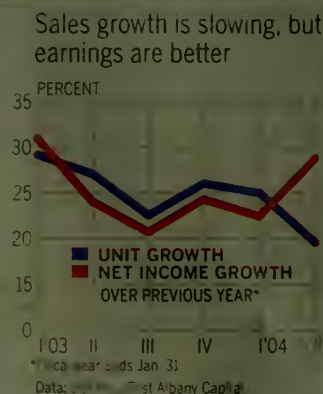
The company, which sells directly to customers over the phone and Internet, acted quickly. It moderated its pricing in markets where it thought there was a risk of losing money. One such niche was low-end consumer PCs, where desktops had dropped to \$299 and notebooks to \$699. Dell also cut the standard warranty of lowest-priced consumer PC from one year to just 90 days. Dell is being similarly pragmatic in China, where it is leaving the low end of the consumer market mostly to local makers, while focusing on higher-margin goods, such as servers.

Dell's rivals are far more constrained. HP, for one, needs consumer PC sales to drive sales of printers, ink cartridges, and digital cameras, which bring much higher profits. And it dare not raise prices lest it lose market share to such aggressive players as eMachines and Acer. Sam Szteinbaum, HP's general manager for consumer PCs in North America, says "we need to ensure we are competitive in all PC categories—even low-end boxes."

Dell's fatter PC profits should give it room to keep the heat on HP in printers, servers, and storage gear. The company is readying its first color laser printer, a key area of strength for HP. "We're not backing off," says Rollins. Given Dell's history, you can bank on that. ■

—By Andrew Park, with Lauren Young in New York, and bureau reporters

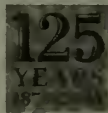
DELL'S PROFIT PUSH



WHY DO WE WORK?

Do you know we're protected from all the what-ifs. What if we aren't able to work? How will the bills get paid? Who can others count on, if they can't count on us? We understand. That's why our financial representatives are offering a guide that makes benefits like life insurance and disability insurance much easier to understand. It's called From Here to Security.SM And it provides the kinds of tools, guidance and answers you need to take control and protect your future. So that even if you can't predict the what-ifs, you can definitely handle them. For more information, contact your financial representative or visit www.principal.com/fromheretosecurity.

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News In Biz This Week

EDITED BY MONICA ROMAN

HEADLINER

JOHN EYLER



'R' THEY OR 'R'N'T THEY?

Will Toys 'R' Us keep its first name? That's what Chief Executive John Eyler Jr. has to decide. After announcing on Aug. 11 that he may spin off the company's Babies 'R' Us unit and sell its core toy business, Eyler told analysts on Aug. 24 that talk of selling may be premature. "The past few months have been a time of rigorous reevaluation for Toys 'R' Us," Eyler said. "The next 120 days are key."

When it released its second-quarter results on Aug. 24, Toys 'R' Us topped Wall Street's estimates. But margins are miserable thanks to intense competition from Wal-Mart Stores and others. In the first half of the year, Toys 'R' Us lost \$207 million, on \$4.1 billion in sales.

To turn things around, analysts say Eyler is working on a last-ditch strategy. One idea: Adding food and arcade games in some of its 684 stores, creating a "toy fair" environment. Such an idea couldn't be implemented until next year. Meantime, the holiday selling season is just around the corner and Eyler needs strong sales to buy time.

—David Kiley

A FINE MESS FOR SHELL

Is the worst over for Royal Dutch/Shell Group? On Aug. 24, Britain's Financial Services Authority said it was fining Shell about \$31 million for "committing market abuse" by misstating its proven reserves between 1998 and 2003. It's the largest fine ever imposed by the FSA and comes on top of the \$120 million settlement that Shell has agreed to pay the Securities & Exchange Commission. Shell settled without admitting or denying regulators' claims. Jeroen van der Veer, chairman of Shell's committee of managing directors, said the settlements represent "another significant step for Shell in putting the reserves issues behind us." But regulators on both sides of the Atlantic are still probing. The SEC is investigating the individuals involved, while the FSA says it is looking into "other aspects" of the matter.

A MIXED BAG FOR BOEING

Singapore Airlines dealt Boeing



a blow by deciding not to order the new 7E7 aircraft. With most U.S. airlines hobbled financially, Boeing is looking for foreign customers for the 7E7, a midsize jet that promises 20% better fuel efficiency than existing planes. But after securing a

launch order of 50 7E7s from Japan's All Nippon Airways earlier this year, Boeing has logged no other firm orders for the plane. Singapore said that the 7E7 "did not meet [its] financial criteria." Singapore is considered a trendsetter, and carriers such as Malaysia Airlines and Cathay Pacific Airways were waiting to see whether it would pick the 7E7. Boeing got a consolation prize, though, as Singapore ordered 13 Boeing 777s, giving it a victory over arch-rival Airbus. (For a story on Boeing's defense business, see page 100.)

KODAK DIGS INTO DIGITAL

Moving to bolster its digital photography business, Eastman Kodak on Aug. 24 announced it was buying a National Semiconductor unit that develops and makes image sensors. The deal, terms of which were not disclosed, represents another step in Kodak's move away from traditional film. National Semi's image-sensor chips could help Kodak break into the market for cameras in cellular phones and other handheld devices. Kodak plans to spend \$3 billion by 2006 to capture more share in the growing digital imaging business.

WHY HOUSING IS RATTLED

Higher interest rates are taking a toll on housing demand. On Aug. 25, the Commerce Dept. reported that July sales of new homes fell 6.4%, to a 1.13 million annual pace. Although still high by historical standards, that marks the lowest rate since December. The Mortgage Bankers Assn., meanwhile, said that new applications for

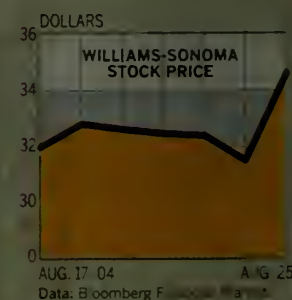
home loans fell 6.3%. "There is some inevitable cooling off from the second quarter, which was an all-time high," said David Seiders, chief economist at the National Association of Home Builders. He still expects new home sales to hit a record this year up 7% from 2003 to 1.16 million.

ET CETERA...

» The founding family will lose a controlling interest in winemaker Robert Mondavi under a reorganization plan.
» H&R Block posted a \$44.1 million first-quarter loss.
» General Motors pulled an ad showing a boy driving a Corvette following protests by consumer safety groups.

CLOSING BELL

Sales are cookin' at Williams-Sonoma. Shares of the kitchenware and furniture retailer jumped 10%, to \$34.64, on Aug. 25 after it reported strong quarterly results, due largely to strength at its Pottery Barn chain. The retailer also raised its forecast for the year.



The Resourceful Business Traveler

Frequent business travelers are becoming more resourceful in finding travel suppliers who meet their growing needs. Travelers are looking far beyond the straightforward services that hotels and airlines offered ten years ago: club floors, business centers, cable access, and in-room coffeemakers at hotels; in-flight phones, cushy business-class airport lounges, and amenities like limousine airport transfers for first- and business-class passengers by the airlines.

Today, directing superlative service to business travelers means all of the above and more. Staying productive on the road is one of the trickiest parts of business travel. Juggling schedules, navigating unfamiliar territory, and working without benefit of one's staff is challenge enough – add to the mix fatigue and stress, and that's a recipe for a lot of lost productivity. But savvy travelers are taking advantage of the wider-range of products and services developed by hoteliers and airline executives to ease the life of the road warrior, from in-room, high-speed Internet access and unlimited local and long distance calls at hotels, to public WI-FI hot spots and kiosks at airports, as well as in-the-air access to two-way e-mail, and instant and text messaging service. Read on to learn more about the latest in travel resources.

The Integrated Business Solution

Hotel room design at the most progressive hotel chains now focuses on the comforts of home – and home office: pillowtop mattresses, white noise machines, ergonomic desk chairs and task lighting. To help guests stay productive, hotel rooms are wired to accommodate lots of plug-in devices – laptop, printer, PDA, cell phone – and public spaces are wired, so to speak, for Wi-Fi.

Hilton has bundled all of these business traveler-friendly amenities into what it calls the Hilton Integrated Business Solution. Now available at all Hilton hotels across the U.S., it includes a series of important offerings:

- **High-speed Internet access**, either wired or wireless, is available in guest-rooms and meeting rooms; wireless high-speed Internet access points (or Wi-Fi hotspots) are provided in lobbies, lounges, restaurants and public areas of all Hilton hotels as well.
- **A 24-hour, self-service business center** at each hotel will offer individual workstations, document printing and copying services (including access to remote guest printing requests), essential office supplies and PCs equipped with the popular business productivity programs, high-speed Internet access, and CD



burners. Secure remote guest printing services, offered via preferred partner PrinterOn®, allows guests to connect their notebook computer or supported mobile/wireless device to the hotel's high-speed Internet service. By following a simple set of on-screen instructions from their preferred Internet connection application, guests will be able to send their documents, spreadsheets and presentations securely to the hotel's new 24-hour self-service business center without special cables, drivers or technical support.

■ **Mail and shipping services** will be available in the business center, where there is a selection of packing supplies and materials (including overnight delivery envelopes, small and medium-sized boxes). To round out the technology and service offerings, all guestrooms at Hilton are offering spacious work desks, comfortable chairs, task lighting and power/communication outlets at desk height.

Fees for Internet access as well as mail and shipping services are set by each hotel locally, and can be charged to a credit card (and soon to a hotel guest's room folio). Remote guest printing services are complimentary when accessed through the hotel's high-speed Internet service.

"The Hilton Integrated Business Solution has been designed for today's professionals on the go, whose demands to stay connected with clients and customers continue to become more of a challenge each and every day," said Jeffrey Diskin, senior vice president – brand management for Hilton Hotels & Resorts. "By providing a consistent, integrated and seamless standard of important business services at our Hilton

hotels locations across North America, we can ensure that our loyal guests are rewarded with an environment that helps them to conduct their business more effectively and easier than ever before."

Introducing the Creativity Suite

Hilton's Embassy Suites brand offers a totally new type of hotel room it calls a Creativity Suite, designed to stimulate creativity – and, by extension, traveler productivity. Creativity Suites come with sectional sofas that can easily be rearranged for impromptu meetings; plasma screen televisions, a Bose 3-2-1 Home Entertainment System, an iMac computer and even a Sharper Image full-body massage chair. Each room of the suite is equipped with tools to help guests stimulate and capture creative thinking. One of the living room walls is a chalkboard. A selection of art supplies is part of each suite's "invention box."

British Airways has just introduced The Sleeper Service, a new service in Club World on selected overnight flights from North America and the Middle East to London Heathrow.

The minibar has brain food – Soy Crisps and Soy Nuts, and Ginkgo biloba and energy-boosting Ginseng supplements. Even the shower features a writing board and grease pencils should inspiration strike mid-shampoo...

A New Service in Club World

Hotel rooms may have gotten more comfortable. So too have airline seats – particularly on long-haul flights in Business Class.

British Airways has just introduced The Sleeper Service, a new service in Club World on selected overnight flights from North America and the Middle East to London Heathrow.



The Sleeper Service now offers up to five dining options throughout one's journey, a more tranquil cabin with fewer announcements, and the usual complimentary spa treatments.

Before the flight on North America services, the evening begins with a pre-flight supper in the Terraces Lounge. After you have boarded your flight, you'll be offered the NightCap service – such as hot chocolate and warm cookies – to help you settle in. The seat morphs into a fully flat, surprisingly comfortable bed

with large pillows and thick blankets with luxurious double-sided cotton.

To maximize sleep time, the cabin crew will dim the lights soon after takeoff, and announcements and trolley movements are kept to a minimum. If you do feel a bit peckish at any time, there's Midnight Munchies in the galley where an array of fruits, cheeses, ice cream and snacks is there for the taking. In the morning, you can have breakfast in bed, or you can advise the cabin crew that you'd like to sleep as long as possible.

After your flight, you can prepare for the day ahead at the London Heathrow Arrivals Lounge. There's a power shower and spa treatments; Molton Brown Traveller Spa massage or mini-facial is particularly restorative. If you need to smarten up your clothes, a valet will do pressing. And if you're hungry, you can also enjoy a hearty English Breakfast in the Dining Terrace.





The new Hilton HHonors. As individual as you are.

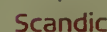
From the way you pack your suitcase to the way you order your coffee, you've got a style all your own. And now, to match it, the new Hilton HHonors® offers you more flexibility than ever before—so you can Double Dip®, your way. Beginning July 1, 2004, you can choose your earnings style from these three options:

Points & Variable Miles:	10 HHonors Base points + 1 airline mile per eligible dollar spent
Points & Fixed Miles:	10 HHonors Base points per eligible dollar spent + 500 miles per stay (100 miles at Hampton® and Scandic)
Points & Points:	15 HHonors points per eligible dollar spent

Just select the option you prefer, in your HHonors membership profile online, at hiltonhhonors.com/myway. The new Hilton HHonors. You keep being you. We'll keep being what you want.

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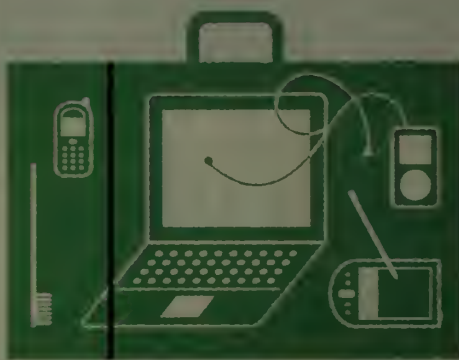
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Want to streamline the check-in process? **Starwood Hotels & Resorts Worldwide, Inc.** is testing self-service kiosk applications at the 1,215-room Sheraton Boston Hotel and the 509-room W New York-Times Square. Located in each of the hotels' lobbies, and similar to airline kiosks, the Starwood system allows guests to check in and out of the hotel by simply swiping a credit card. Check-in takes less than 45 seconds, as compared to several minutes using the traditional front desk check-in method...

Fairmont Hotels & Resorts has teamed up with **Hewlett-Packard** to bring mobile technology to members of Fairmont's guest recognition program,

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Can't concentrate on an empty stomach? Following the decision by many airlines to reduce, or eliminate, in-flight meal service, **The Ritz-Carlton Hotel Company** has reintroduced its "Flight Bites" program, a convenient way to bring a snack or meal aboard a flight. Packed into a small shopping bag, or an

easy-to-handle box, "Flight Bites" can be ordered through the room service menu at many Ritz-Carlton hotels and resorts. Menu selections vary from a breakfast croissant, piece of fruit, and bottled water to "upgraded" choices of sandwiches, cookies/brownies, and a small bottle of wine for those who prefer to eat First Class, even when they're sitting in coach. "Keeping in mind the new restrictions on carry-on luggage, we are making these meals as compact as possible, to fit into a briefcase or carry-on bag, with ease," said Simon Cooper, president and chief operating officer.

Here's a tip to keep your airport downtime at a minimum. Check yourself in online before you leave for your flight, and you can skip the lines at the ticket counter. Virtually, all major domestic airlines now allow Internet check-in up to 24 hours before a flight. Some carriers even let you print out your own boarding pass from your home or office computer; otherwise, you can use a self-serve kiosk in the airport lobby. Most airlines will even allow you to change a seat assignment and/or get an upgrade, and credit frequent flyer programs for a flight leg during the online check-in process.

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BRITISH AIRWAYS



SOUTH KOREA

BUILDING A 'CAMRY FIGHTER'

Can Hyundai transform itself into one of the world's top auto makers? A lot is riding on its new Sonata sedan

BEHIND A CORDON OF tight security at Hyundai Motor Co.'s plant in Asan, about 62 miles southwest of Seoul, hundreds of identical sedans in muted silver, beige, green, and other colors are in the midst of nearly nonstop testing on a 2-mile track. But few outside the plant have ever seen this model. The car, code-named NF, is the successor to the company's mainstay Sonata sedan, though it has been through a bumper-to-bumper remake, with a more powerful engine, a bigger cabin, and superior suspension.

Hyundai has a lot riding on this car. Execs are betting that the new Sonata—to be launched in Korea on Sept. 1, and in the U.S. and elsewhere next spring—will challenge Toyota's Camry, Honda's Accord, and Ford's Taurus for the hearts and wallets of U.S. drivers, and help catapult Hyundai into the ranks of the world's top carmakers. They aim to sell as many as 180,000 Sonatas a year at prices likely to top \$22,000. "Our goal is not to make a one-off hit," says Choi Jong Min, the car's chief designer. "This will spearhead our efforts to boost our brand image and end Hyundai's reputation as a discount marque."

"A DOABLE TARGET"

HYUNDAI HOPES the new Sonata and a small SUV called the Tucson will be the first in a string of winners. They had better be. Hyundai hasn't launched a new vehicle in two years, and dealers want to see the product drought end. Over the next three years, Hyundai and its subsidiary, Kia Motors Corp., will introduce a dozen new models. The company wants to double group sales, to 5.5 million vehicles annual-

ly, by 2010, with much of that growth coming from new plants in the U.S., China, India, and Europe. Hyundai's aim: to leapfrog PSA Peugeot Citroën and Renault to rival Volkswagen as the fifth-largest carmaker on earth, up from No.8 today. "Hyundai is gearing up to become a truly

global player," says Lee Jae Wa, Hyundai's marketing chief.

It has been six years since late-night host Jay Leno compared a Hyundai to a luge sled (the car "has no room, you have to push it to get going, and it only goes downhill"). Rivals aren't laughing now.

In 2000, Chairman Chung Mong Koo promised Hyundai would rival Toyota in quality, reliability and customer satisfaction. This year, he delivered: On Apr. 2, J.D. Power & Associates Inc. survey of initial quality—measuring the number of complaints in the first 90 days of ownership—showed Hyundai in a virtual dead heat with its Japanese rivals. Hyundai and Honda Motor Co. tied for No.2 with 10 problems per 100 cars, just behind Toyota Motor Corp.'s 10. Hyundai's "momentum is significant," says John Humphrey, chief of international operations at J.D. Power. He calls Hyundai's sales goal "ambitious, but a doable target."

The quality improvement is showing up in Hyundai's results. Last year profits jumped 21%, to \$1.51 billion, even as sales fell 5.2%, to \$21.52 billion because of a slump in Korean consumer spending. This year Hyundai is on track to see profit growth of 23% as sales rise nearly 11%, according to Daewoo Securities Co. "We're poised to have a record year," says marketing chief Lee.

Once the new Sonata hits the road, Hyundai wants to reinvig-



NEW SONATA
(Unofficial photo)

U-Turn

How Hyundai Motor has gone from talk-show joke to talk of the town

QUALITY: Relentless focus on fixing even the smallest problems has put Hyundai alongside Toyota and Honda atop customer satisfaction surveys.

R&D: Opened design and R&D shops in the U.S., Europe, and Japan, and since 1999 has poured \$5.4 billion into developing new models, engines, and transmissions.

GLOBALIZATION: Exports now account for 64% of sales, up from half five years ago. New overseas plants will help double production capacity, to 5 million cars annually, by 2010.

SCALE: Boosted capacity by 50% in 1998 via purchase of failing rival Kia Motors, giving Hyundai more heft and allowing it to demand better prices from suppliers.



WELDING STATION
The focus on
quality is paying off

at Hyundai's Power Train R&D Center in Namyang, south of Seoul, tore apart the engines of more than 70 midsize sedans. That exercise helped them design a 3.3-liter V-6 and a 2.4-liter, four-cylinder engine, each of which they say cranks out more horsepower and torque than any engine in its class—though they decline to give data on performance. And to make sure Sonata drivers get more oomph than those piloting Camrys, Hyundai plans to equip most of its U.S.-bound Sonatas with the new V-6. The price hasn't been set, but the V-6 is expected to run about the same as a four-cylinder Camry. Offering more power for less could be a big selling point, since 80% of Camry buyers settle for the cheaper four-cylinders.

Hyundai still faces some challenges. One issue is whether it can crack the big leagues without pickup trucks and monster SUVs that are so popular in the U.S. "It's hard not to have a product in the largest segment of the market," acknowledges Ed Bradley, vice-president of Hyundai's U.S. sales unit. And despite the initial quality gains, Hyundai has yet to prove its cars are durable. In the most recent J.D. Power dependability study—which measured customer satisfaction with 2001 models—Hyundai placed 14th among 17 auto makers. Worse, Kia still ranks near the bottom on both initial quality and dependability. Hyundai executives counter that

their dependability numbers will rise, since the results of the quality push won't be fully seen for a couple of years. As for Kia, they say the models being rated were developed before Hyundai took the company over, and that its new cars will fare much better.

For now, though, the future looks bright. If the new Sonata proves a hit, Hyundai will likely see its

U.S. sales continue to climb. If Hyundai can then consolidate its quality gains and keep churning out new models, the big auto makers in Europe, the U.S., and Japan would do well to keep an eye in the rearview mirror for this Korean speedster. ■

—By Moon Ihlwan in Asan, South Korea, with Chester Dawson in New York

entire lineup. By 2008, it will replace its four other existing models, including the Elantra and XG 350 sedans, and add two new SUVs and a minivan. Kia will reamp its Rio and Optima sedans, the Sportage SUV, and the Sedona minivan. That's one of the best pipelines in the industry, which should keep customers hitting the showrooms—and allow Hyundai to bump prices up toward Toyota's levels. Above all, the Sonata has to charm U.S. drivers. The new model, which will be the first vehicle built at a \$1 billion plant in Montgomery, Ala., is vital in meeting the company's U.S. sales targets. Hyundai wants to boost American sales by 20% from last year's level by 2006, to 500,000 units, and double that by 2010. To get a sense of what Americans want, it spent years surveying U.S. consumer tastes. Its sleeker silhouette stems from a "concept clinic" in San Diego four years ago. More

than 200 people rated Sonata rivals on everything from looks to power and pricing. Participants especially liked the Audi A6, which became a key benchmark for the new Sonata. "Internally, NF is known as an affordable A6," says a Hyundai director.

The real benchmark, though, is the Camry; indeed, Hyundai execs refer to the Sonata as their "Camry fighter." Hyundai has long tried to close the quality gap with the top-selling sedan in the U.S., and the car served as the reference point for the NF's design, cabin size, and handling. "We made sure NF performs better or at least matches Camry's performance in every aspect," says Lee.

One key aspect is the motor. Engineers

Hyundai wants to double sales, to 5.5 million vehicles a year, by 2010

EUROPE

SEX-BIAS SUITS: THE FIGHT GETS UGLY

Cases are piling up in Britain—and new rules may spread them around the EU

THE SOUTH LONDON town of Croydon is just another sprawling nondescript suburb. But on Aug. 31, it will become the center of the biggest and potentially most important sex-discrimination suit Europe has ever witnessed. That's when London-based Stephanie Villalba, 42, who ran Merrill Lynch & Co.'s private client business in Europe, will resume testimony before an employment tribunal. Villalba is suing Merrill for sex discrimination, unequal pay, and unfair dismissal. The multilingual Harvard graduate was dismissed in July, 2003, for "poor performance." Villalba asserts she was "bullied, belittled, undermined, and underpaid." Her suit seeks record damages of \$13.5 million.

Merrill says Villalba's claims are "completely at odds with the evidence of other female colleagues." The firm also asserts that gender discrimination was not an issue: Villalba was replaced by another woman, who, the brokerage says, "has been very successful." But Villalba isn't the only woman working for Merrill in Britain who's complaining loudly about sexual discrimination or harassment. In July the firm paid out close to \$900,000 in an out-of-court settlement to former in-house lawyer Elizabeth Weston after a Merrill executive allegedly made lewd comments about her breasts and sex life at a Christmas party in London. Merrill denies wrongdoing in the Weston case.

Europeans—and Americans—who think sex-discrimination and harassment suits are a purely U.S. phenomenon had better think again. Villalba's is just the latest in a slew of claims against British employers. In the year ending Apr. 30, there were 14,284 sex-discrimination claims filed at Britain's Employment Tribunals Service, judicial bodies that resolve em-

ployment-related disputes, compared with 24,362 filed in the U.S. at the Equal Employment Opportunities Commission last year. Since most British cases are withdrawn or settled before getting to a tribunal, lawyers say the numbers of complaints are in fact much higher. "For every case that makes it into the newspaper, there are hundreds which don't," says Joanna Wade, a partner at Palmer Wade, a London law firm specializing in employment-discrimination cases.

Companies on the Continent so far have been largely unaffected. But their reprieve could soon come to an end. A new European Union rule taking effect in October, 2005, for the first time defines sexual harassment as a form of discrimination. It also requires EU countries to establish judicial or administrative bodies to enforce equal treatment in the workplace and to remove any caps on awards in such cases. Employers are encouraged to take measures to prevent discrimination. These changes build on a 1997 rule that required EU countries by 2001 to shift the burden of proof in sex-discrimination cases from employees—where it lies in the U.S.—to employers. "This will have an enormous impact on employment practices," says James A. Passamano, a former top official at the EEOC and an adjunct professor of European law at South Texas College of Law in Houston.

SIX-FIGURE SETTLEMENTS

EUROPEANS ONLY have to look across the Channel to see what's next. Britain was the first in the EU to eliminate the cap on awards in discrimination claims in 1993. Then, in 2001, it shifted the burden of proof to the employer. "These claims are hitting Britain fast and furious, and European companies are naive if they think it won't happen to them," says Gina M. Higgins, managing director at Marsh Inc., a



CHRIS YOUNG/PA PHOTOS

global risk and insurance services firm in New York.

For now, the cases grabbing the headlines are those involving the City, London's financial district. The majority of women behind these claims tend to be high-fliers whose six-figure settlements reflect the sizable salaries. In April, senior women lawyers Sian Heard and Sian Fellows won \$1.7 million after an employment tribunal ruled that a glass ceiling at London law firm Sinclair Roche & Temperley had stunted their careers. In testimony describing the male culture of the firm, which is appealing the decision, the women claimed a senior executive told some male employees that they should be firm "to get in better-looking recruits rather than you old bags." The case has been sent back to an employment appeals tribunal to be reheard.

One reason London's financial firms seem to have a disproportionate number of cases against them is that women bankers, insurers, traders, and analysts earn an average of 43% less than their male colleagues, according to Britain's Equal Opportunities Commission. British women working full-time earn an average of 21% less than men, compared with the average pay gap of 16% across the European Union, calculates Eurostat.

VILLALBA Suing Merrill for unfair dismissal and unequal pay

Battling **Sexism** in the City

Female highfliers are beginning to challenge the macho culture of London's financial industry



CASE	CLAIM	STATUS
JULIE BOWER VS. SCHRODER SECURITIES (part of Citigroup)	Securities analyst received substantially smaller bonus than male counterparts and was blocked from advancement; described by her boss in an e-mail as "had cancer, been a pain, and is now pregnant."	WON \$2.5 million in 2002, the largest claim to date.
STEPHANIE VILLALBA VS. MERRILL LYNCH	Former head of European private banking earned substantially less than male counterparts and was belittled by her boss who told her to serve drinks and "sit in the stewardess seat" on a business flight.	CASE RESUMES Aug. 31, 2004. Claims damages of \$13.5 million.
ARIANNA MCGREGOR-MEZZOTERO VS. BNP PARIBAS	Returning from maternity leave, the Italian-born executive's bonuses were slashed and responsibilities reduced.	WON June, 2004. Award to be set in September. BNP is appealing.
ELIZABETH WESTON VS. MERRILL LYNCH	Lawyer allegedly endured unwanted sexual attention and lewd remarks from senior lawyer.	SETTLED out of court in July, 2004, for close to \$900,000. Merrill admits no liability.

Data: U.K. Employment Tribunal Service, *BusinessWeek*

Take Liz Pullen, a regional manager for French waste management company Onyx Environmental Group PLC. The 46-year-old, who had worked at Onyx for six years, learned that during a restructuring, two male colleagues were given a severance package more than twice the size of the one offered to her. She took Onyx to a British employment tribunal. There she found out her colleagues made \$107,000 a year, while she made \$80,000. "I couldn't believe it," she fumes. "I assumed as we were doing the same job that my pay was in line with theirs." She won her case and is anticipating a substantial award. An Onyx spokesman says the company advocates equal opportunity for all and is "considering the tribunal decision."

Across the Channel, it's hard for women even to initiate litigation. "An isolated attempt to kiss someone or sexist comment would not be considered sexual harassment," says Marie-Frédérique Fournier-Gobert, an employment lawyer at Barthélémy et Associés in Paris. Americans find such distinctions disturbing. "The French definition of sexual harassment is what we Americans would call assault and battery," says Michael Rubenstein, co-editor of the

Across the Channel, women have a hard time initiating litigation

Equal Opportunities Review in London. One of the biggest sexual-discrimination awards in France was awarded to a man. After allegedly groping two female colleagues on a business trip, a male employee of an Internet security company lost his job. He then sued his employer for unfair dismissal and won \$616,000 in 2003. Compare that to Florence Buscail, who took IBM France to court for sexual discrimination that same year. The technician, who claimed she had been passed over for promotion and was being paid 30% less than her male colleagues, was awarded \$37,000. IBM France declined comment. It's the same in Germany, even though legislation banning sexual harassment in the workplace has been on the books since 1994. "Some 80% of the few hundred sexual-harassment cases that have been filed in German labor courts have been filed by men," says Kathrin Zippel, an assistant professor at Northeastern University in Boston who is working on a book on sexual harassment in the EU. These are the men who were accused of sexual harassment and punished by their employers. Their cases are usually about claiming back pay or getting reinstated. Zippel says women rarely

file suits. "They don't trust their employers, the male-dominated unions, or the courts to be sympathetic to their claims," she adds.

Some Continental companies are making efforts to change. Patrick Thiebart, an employment lawyer with Paris-based law firm Caubet Chouchana Meyer, says companies "are increasingly asking us to review their employment practices and help put specific procedures in place to prevent harassment." German giant Siemens has had a program in place for the last four years that focuses on the advancement of all groups, especially women. "We're doing this because there's a business case for it. When you have a problem to solve and only look at it through the eyes of a group of German white males, you'll probably solve the problem. But the chances are better if you have a group with different backgrounds," says Peter Ramm, director of international social policy in Siemens' corporate personnel department.

Still, European companies, for the most part, look at the rise in sex-discrimination litigation with bemusement. Says one London lawyer with a major international firm: "When I talk to my colleagues in Europe about sex discrimination, their eyes glaze over." If a wave of lawsuits hits them next year, they'll wake up fast. ■

—By Kerry Capell, with Laura Cohn in London, Rachel Tiplady in Paris, and Jack Ewing in Frankfurt

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—By Kerry Capell, with Laura Cohn in London, Rachel Tiplady in Paris, and Jack Ewing in Frankfurt

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TELECOM

CELL PHONES: DON'T COUNT LINUX OUT

It's catching on slower than expected, but more companies are signing up

IN FEBRUARY, 2003, ELECTRONICS giant Motorola Inc. stunned the mobile-phone business with a bold change of course. During the industry's annual shindig in Cannes, the Schaumburg (Ill.) company announced the world's first handset built around the Linux operating system and unveiled plans to use the populist software in consumer phones from then on. Pundits saw this as a slap at Symbian Ltd., the London software consortium Motorola co-founded five years earlier with Nokia Corp. and Ericsson to develop software for feature-rich smart phones. It was also a major lift for Linux, the grassroots operating system that until then was used mainly on servers.

So far, Linux phones haven't lived up to the hype. Motorola has delivered two handsets, both in China, with two more on the way. But only 1.1 million Linux-based phones are expected to ship this year, vs. 14 million using Symbian system, estimates researcher Strategy Analytics in London. Downsizing Linux to fit into mobile phones took longer than predicted, and the software has a ways to go before it equals the sophistication of Symbian's package or the mobile phone version of Microsoft Windows. Motorola nevertheless remains a believer, says Scott Durchslag, general manager of Motorola's personal communications sector for Southeast Asia. "Linux is more flexible and opens

you up to the innovation of developers around the world," he says.

Indeed, behind the scenes, Linux is picking up steam, especially in Asia. Korean giant Samsung Group is selling a Linux-based phone called the SCH-i519 in China and has other models on the way. Chinese telecom equipment maker Datang said in July that it will use Linux to power upcoming phones for third-generation (3G) networks. And Sunnyvale (Calif.)-based MontaVista Software Inc., which supplies the version of Linux used

of "open" source code that phone makers can modify to suit their needs. Plus millions of programmers around the world write Linux software. One misconception: Linux isn't necessarily free. While phone makers could use no-cost versions of Linux, most license packages are offered from companies like MontaVista. Even so, Linux costs less than the \$5 to \$7 per handset vendors pay for Symbian or Microsoft software.

Top-of-the-line smart phones that could replace a laptop PC and connect to corporate data systems will likely still use Symbian or Windows. But thanks to its low cost, Linux could become the de facto standard for less-sophisticated "feature" phones that add cameras, games, and music—a market that analyst Richard Windsor of Nomura Securities International Inc. in London pegs at 145 million units this year. That's one reason Redwood City (Calif.)-based Openwave Systems Inc., the leading supplier of Web browsers for mobile phones, has recently hitched its wagon to Linux.

WHERE DOCOMO LEADS...

LINUX PHONES, though, tend to gobble up more power than others. A lack of standards could brake development of dependent software. Meanwhile, Symbian CEO David Levin says 30 more Symbian-based handsets are in development by phone makers, adding to the 20 already on the market. "Our biggest advantage is the relationships we have with the world's top phone makers," he says. Still, Linux keeps scoring endorsements. In December pace-setting Japanese wireless operator NTT DoCoMo declared that all its future 3G phones would use either Symbian or Linux: NEC Corp. is working on a Linux model. Shut out of the race was Microsoft (the company declined comment). "Where DoCoMo leads, other wireless carriers tend to follow," says Seamus McAtee, a senior analyst with San Francisco-based Zelus Group Inc.

To be sure, some other mobile phone makers are holding back; Nokia and Sony Ericsson Mobile Communications remain firmly committed to using Symbian. Unlike Linux, "It was designed from the first line of code for smart connected devices," says Tero Poikolainen, vice-president of marketing at Nokia Technology Platforms. But it's clear Linux isn't going away. The battle could get mighty hot in a few years' time. ■

—By Andy Reinhardt in Paris, with Bruce Einhorn in Hong Kong and Mithlwan in Seoul

Linux On The Go

Forecast sales of mobile phones built on Linux

2003	0 million
2004	1.4 million
2005	9.6 million
2006	24.4 million
2007	32.2 million
2008	40.5 million

Data: Nomura Securities International Inc.



UPSTART CALLING
Linux-based Motorola phones are still rare

in most phones, says it has won 10 contracts for handsets using Linux, including several from European makers. "Every single mobile-phone maker is looking at Linux," says Stéphane Deruelle, MontaVista's director for Southern Europe.

What's the attraction? For one thing, nobody owns Linux: It's available in the form

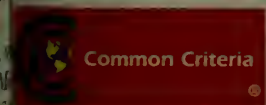


* Trends in Proprietary Information Loss Survey (ASIS 2002). ©2004 Sharp Electronics Corporation

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COMMENTARY

BY GAIL EDMONDSON

Germany: Welfare Reform Won't Cut It

Schröder needs to help business create jobs, not just slash the dole

FROM DORTMUND to Dresden, some 70,000 angry Germans took to the streets on Aug. 23 to vent their rage over recently approved cuts in unemployment benefits. One group of protesters hoisted a symbolic coffin overhead labeled "Germany's future." Government officials say protesters are simply poorly informed about the changes. Dubbed "Hartz IV," after Peter

Hartz, the Volkswagen executive who headed a national commission on labor reform, the law takes full effect in 2006. Under the new rules, an unemployed single worker who previously netted \$1,097 a month in long-term unemployment benefits will have to get by on \$801. Even with the cuts, German jobless benefits will remain well within the European average, economists say. Still, by reducing the payouts, policymakers hope to give Germany's 4 million unemployed a greater incentive to get off the dole.

It's a worthy goal, but the fact is, Chancellor Gerhard Schröder has failed to push through enough free-market reforms during his six years in office to juice job growth. The situation is especially grim in the east, where 36 applicants vie for each opening. So instead of diving back into the labor market, Germany's jobless are being forced to jump into an empty pool.

Schröder must deliver some gains along with the pain. His center-left government needs to move quickly to create the conditions necessary for German companies to begin hiring again. A first step should be to overhaul the anachronistic system of national wage agreements. The deals, negotiated between labor unions and employers' associations, apply to entire industries—and deprive companies of the flexibility to negotiate wages locally or to adjust their staffing levels to the ups and downs of the business cycle. Years of generous settlements have pushed Germany's wage levels so high that many positions are now priced out of the market—forcing companies to transfer production to Poland, India, or China.

Businesses have gotten so desperate that they have devised their own deals. Wielding the threat of offshoring, companies such as Siemens and DaimlerChrysler have recently negotiated agreements at some of their plants to safeguard jobs in exchange for a longer workweek without higher pay. That's encouraging. But Schröder's govern-



LEIPZIG Protesting plans to slash unemployment benefits

ment ought to send a clear signal to the rest of Germany. Instead of legally allowing companies and workers to deviate from union contracts under certain conditions, "the many needs to break the cartel between unions and employers that has led to a market wage level," says Elga Bartsch, executive director of Morgan Stanley in London.

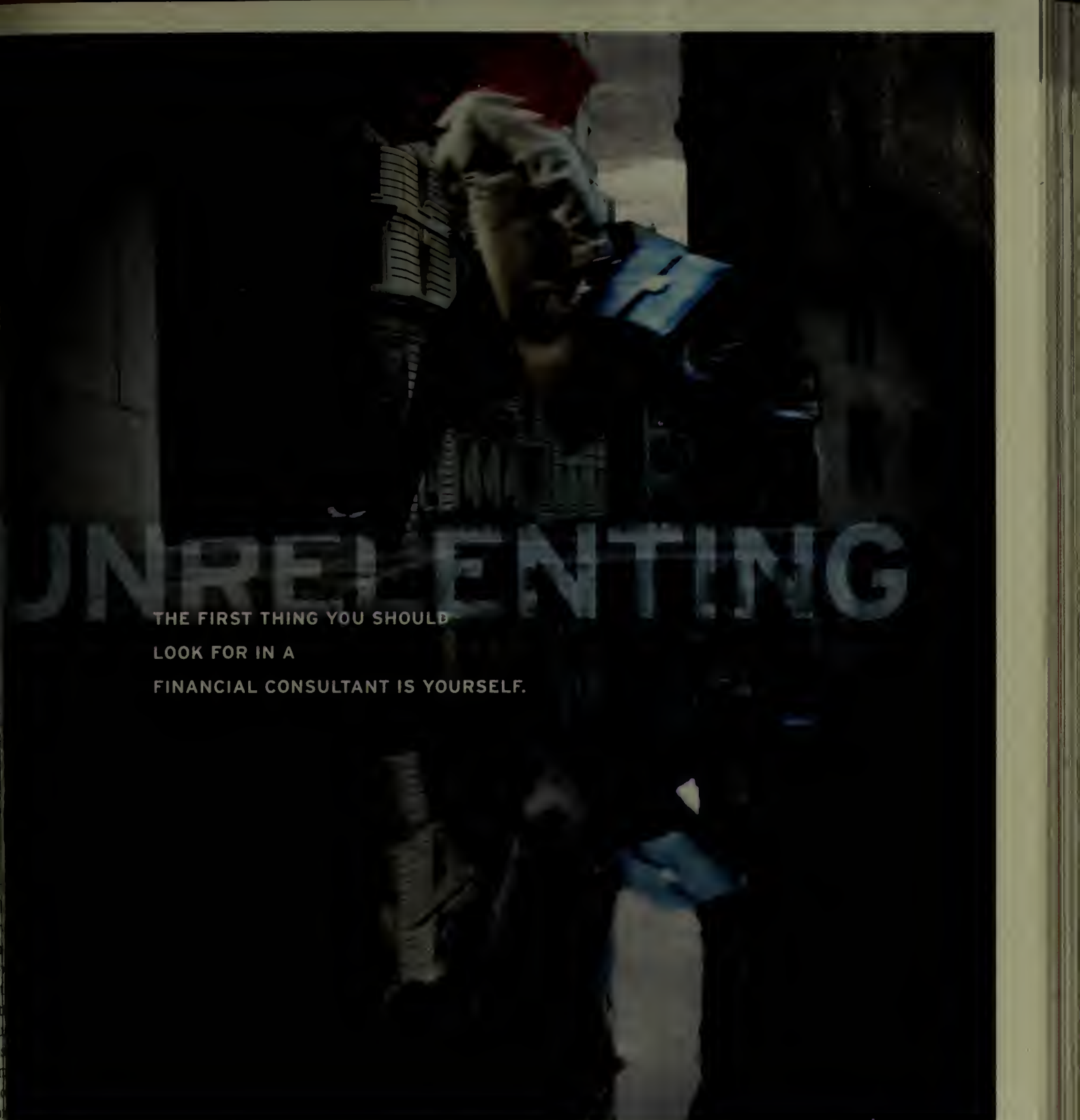
Germany's jobless might be more willing to swallow the govern-

ment's bitter medicine if it was accompanied by serious measures to cut government waste and spur economic growth. Imagine how an unemployed engineer feels knowing that the state still shovels billions into the unprofitable coal industry supporting every worker to the tune of \$85,000 annually. Schröder needs to get serious about cutting \$150 billion in state aid to many industries, and implementing controls on billions in ineffective transfers to east Germany. It would be smarter to spend taxpayer money on education, support for entrepreneurs, and research into new technologies—policies that Finland and Ireland have used to boost economic growth.

Last but not least, the government should encourage the public sector to do more belt-tightening on its own. It's no secret that the sprawling labor force, with its \$66 billion budget and 90,000 civil servants, is miserably ineffective. In 2002 the agency was caught falsifying statistics to improve its image—a scandal that prompted reform. Yet the institution is adamantly resisting change.

Government officials insist they are tackling the obstacles to growth on all fronts and that reform will need time to take effect. But how much time does Germany have? Maybe the protesters carrying the coffin know something the government doesn't.

Companies must be able to deviate legally from union contracts



UNRELENTING

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EDITED BY CHRISTOPHER POWER

Can an Unknown Whip Europe into Shape?

IN LATE JUNE, when Portuguese Prime Minister José Manuel Durão Barroso was chosen by the political leaders of the European Union's 25 member-states as the European Commission's next president, longtime Europe watchers reacted with a mixture of affluement and dismay. Barroso was on virtually no one's list of

potential candidates. French President Jacques Chirac and German Chancellor Gerhard Schröder had lobbied hard for Belgian Prime Minister Guy Verhofstadt, a vocal opponent of the Iraq war, to take over the most important institutional job in the EU. Britain and other states were pushing for Danish center-right leader Anders Fogh Rasmussen or for Spain's Javier Solana. As a deadlock loomed, leaders settled on dark horse Barroso. "José Manuel Durão Barroso ho?" was how one radio dispatch put it.

Winning plaudits

BUT THE 48-year-old former lawyer is winning over many skeptics. By moving quickly to form his commission, he deflected mounting political pressure from large EU states to get favored posts. And his decision to hand over four key commissionerships—competition, trade, internal market, and monetary affairs—to free-market candidates from Britain, Ireland, the Netherlands, and Spain is winning audits. "This puts free-market reformers at the center of gravity," says Julian Lindley-French, course director at the Geneva Center for Security Policy.

It also marks the end of Franco-German domination of the EC decision-making apparatus. Barroso rejected strong pressure from Berlin to name a supercommissioner in charge of economic affairs—with the job going, naturally, to a German bureaucrat, Günther Verheugen. And despite behind-the-scenes strong-arming to have 67-year-old Chirac associate Jacques Barrot succeed competition chief Mario Monti, the job went

to Neelie Kroes, a business-friendly Dutch economist and former transport minister. Barrot, who speaks no English and had no experience in international positions, had to settle for the EC's transport portfolio. "This is an unprecedented humiliation for French diplomacy," is how François Bayrou, a prominent French parliamentarian, puts it.

Barroso, however, cannot afford to burn his bridges to the French and Germans. He will need all the support he can get for what are likely to be his two biggest political battles over the next year. One is his determination to keep opening up Europe's protected service industries. The second task is to set the EC's 2007-13 budget plans. Last December the six biggest net contributors published a joint letter calling for a future cap of the EC budget at just 1% of Europe's gross domestic product. Both outgoing EC President Romano Prodi and Barroso think the proposal insufficient for new efforts, from anti-terrorism to increased research and development expenditures.



BARROSO The new EC President is winning praise

Barroso's no-nonsense determination to boost Europe's lackluster economic performance looks smart. Prodi lost much credibility by badly communicating policies, while his rhetoric about Europe as a superpower was undercut by internal conflicts over the Iraq war, NATO, and relations with the U.S. "Barroso has proven competence and clear-headedness—and competence is always better than rhetoric," says Larry Siedentop, a specialist on European political affairs at Oxford University. Barroso's honeymoon will not last forever, but he is getting off to a surprisingly good start. ■

—By John Rossant in Paris

GLOBAL WRAPUP

RUSSIAN AIR DISASTER

TWO RUSSIAN airliners flying from Moscow to cities in southern Russia crashed almost simultaneously on Aug. 24, killing all 89 on board. Police investigators have found no initial evidence of terrorism, but many experts suspect foul play. The disaster comes just days before presidential elections in Chechnya, where Russia is at war with separatist rebels, and follows an intensification of violence there that has killed dozens in recent days. Chechen groups have been responsible for several previous terrorist attacks in Russia, including the October, 2002, siege of a Moscow theater that left 129 hostages dead. The Aug. 29 poll will elect a successor to Chechnya's former President, **Akhmad Kadyrov**, who was assassinated in a bomb attack in May. The main rebel group denies responsibility for the crashes.

STRONG DEBUT FOR TATA CONSULTANCY

ON AUG. 25, Tata Consultancy Services, Asia's largest software services company, made its long-awaited debut on the Bombay Stock Exchange. The \$18.80 stock jumped 23% on the first day of trading. The listing has brought into the open India's pioneering software services outfit, which before was privately held by the \$12.8 billion Tata Group. Together with Infosys and Wipro, India's three IT giants are now among the top 10 of the world's software services companies, along with Accenture, IBM, Electronic Data Systems, and CSC. With the TCS listing, the total market capitalization of Tata Group's listed companies, including Tata Steel and Tata Motors, now exceeds \$22 billion, or 10% of the Bombay Stock Exchange.

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Progress Energy

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INNOVATIVE ENERGY SOLUTIONS FOR TODAY AND TOMORROW

Prices for electricity and natural gas have risen dramatically in the past couple of years while demand for these basic energy commodities continues to grow. As a result, the economics for innovative energy solution providers has improved as have consumers' willingness to adopt these new solutions.

Business consumers are leading the adoption cycle due to their higher consumption, added to the need to stay competitive in an increasingly global marketplace. At the same time, businesses demand energy solutions that are hassle-free, non-invasive and produce a return on investment in a very short timeframe.

Perhaps the quickest realization of savings comes from switching electricity or gas suppliers in those markets where consumers have a choice. Energy marketers, such as electricAmerica, a unit of Commerce Energy Group, have perfected the hassle-free return businesses are seeking. For example, electricAmerica can save businesses money by switching a customer via phone in less than 10 minutes, and has automated the process to the point where the customer has to do no more than pay the bill each month. According to Peter Weigand, President of Commerce

Energy Group, "It's simple to do and provides an immediate economic benefit to the customer, which makes it hard to understand why every state hasn't embraced customer choice for business consumers."

Besides saving money on the commodity itself, there are numerous innovations that serve to manage the consumption and save money through energy efficiency. Maximum Performance Group's eMac technology mounts on commercial rooftop air conditioners and networks the location to monitor and control all the other energy consuming devices. Utilizing wireless communication technology and a centralized control room, Maximum Performance Group manages energy consumption, minimizes the cycles on equipment and

exceed 10 percent, with multiple location businesses often realizing even greater savings," says Maximum Performance Group CEO, Leonard Pisano.

For larger industrial consumers where energy represents a significant portion of raw material costs, there are several strategies being pursued that serve to lower costs. One such strategy in natural gas has industrial customers partnering with exploration and production companies to participate in drilling new gas wells and thus have ownership in the gas reserves found. This effectively gives the industrial customer a hedge on future consumption using physical natural gas reserves, which are typically much cheaper at the finding cost level. Once the natural gas is in production, industrial consumers

Tomorrow's energy innovations,
in many cases, are already in use today.

determines maintenance requirements for all of the buildings connected to its network. Using the Web, customers set the operating parameters, such as desired temperatures and business hours, and eMac technology manages energy consumption devices remotely in order to maximize efficiencies while maintaining the customer's operating parameters. "Energy savings typically

can make arrangements for delivery or swap the gas for supply delivered to their facility.

Tomorrow's energy innovations, in many cases, are already in use today. Broader market adoption will make building and implementing these and other solutions even more effective in reducing energy bills.

CAPITALIZING ON EMERGING ENERGY MARKETS



*Ian Carter, Chairman and CEO
Commerce Energy Group*

Commerce Energy Group is a diversified independent energy services provider focused on both regulated and deregulated energy markets.

Founded in 1997, the company's electricAmerica™ brand is a national leader in electric market customer choice in Pennsylvania, Michigan, California, and New Jersey. The company is currently implementing initiatives to expand into new markets and balance its electric portfolio with the introduction of natural gas.

By bundling energy efficiency products and services, Commerce Energy Group is expanding its customer relationships to include both the supply and demand requirements of its customers. This diversification strategy has led to longer-term customer retention, which is good for the customer and adds value to the shareholders.

The outsourced services business unit rounds out Commerce Energy Group's diversified strategy by offering back-office services, data management, and consulting to energy companies in all market segments. The core expertise within the outsourced services group creates a distinct competitive advantage while providing a third profit center.

Commerce Energy Group is dedicated to creating, developing, and capitalizing on emerging energy opportunities.



Defining the Market

www.commerceenergy.com

When Hurricane Charley swept through Florida and the Carolinas in mid-August, Outback Steakhouse closed six of its restaurants for days, not only because of high winds threatening the area, but also because they were without power and water. American business—and the American home—runs on reliable, affordable power.

For almost a century, regulated utilities electrified the country. When you flipped the switch, the lights invariably came on, and the government usually made sure the cost didn't break your budget. As electric generation feedstock costs became more volatile, the government had more difficulty assuring reliability and affordability. At the same time, consumers wanted more control over their electric costs and competition for their business. The result is that competitive retail energy markets have spread and matured steadily these past several years.

As recent energy prices have risen, sellers and buyers want more control over their generation and usage. So an older and wiser energy market is cautiously optimistic about new technologies, processes and, yes, even regulations, they hope will result in more sustainable and fair competition. More advanced demand-monitoring technology, more flexible supply options, and more sophisticated regulatory protections clarify energy choices for consumers, particularly industrial and commercial users.

Increasingly, even energy suppliers, who traditionally made their money by delivering more energy, find that conservation tools and value-added services not only make them a more attractive supplier, but also constitute a new profit center. Competition also pushes traditional utilities toward innovation in the area of their greatest strength—power quality and reliability. Regulations now require utilities to provide equal access to their transmission wires, regardless of whether

they or a competitor are supplying the electrons themselves. Despite more suppliers using the system, utilities are still responsible for system reliability, even in the face of natural disasters. As a result some utilities employ their engineering expertise to develop more powerful and consistent standby systems for those customers particularly vulnerable to supply interruptions. It could be a hospital with floors of patients on life support, or a large manufacturer who would lose millions with even a temporary shutdown of operations.

Progress Energy, for example, offers their largest users customized on-site power quality and reliability services, owned and operated by either the utility or the customer. "We have a responsibility to have the people and resources dedicated to providing outstanding reliability and service, particularly in this time of growth and economic development in the north Florida area," said Martha Barnwell, first vice president of Progress Energy's North Coastal operating region in a recent press release.

Some contend that competition discourages critical investment in the maintenance and improvement of the basic wires used to deliver electricity to the bulk of consumers, one of the factors that contributed to the 2003 Blackout. Though regulators continue to control utility profits on such investments, scrimping on basic infrastructure may be short-sighted. Even in deregulated markets, it is the local power company's name on the shirts of the repair crews seen in the wake of disasters like Hurricane Charley.

This special advertising section was produced by Skipping Stone Inc., an energy consulting company founded in 1996 by leaders from within the energy industry. Written by Meg Healy.

www.skippingstone.com

For more information please contact Verna Ray, vray@skippingstone.com

COMMENTARY

BY LOUIS LAVELLE

Smoke, Mirrors, and Shareholder Settlements

TO HEAR THE LAWYERS tell it, the decision by Applied Micro Circuits Corp. to settle a shareholder class action in June was nothing short of monumental.

After three years of litigation, Applied Micro signed off on what is known as a "therapeutic" settlement: It would add two new independent directors, eliminate insiders from three key committees, and

make dozens of other corporate governance changes. That, said Warren J. Robbins, the shareholders' lawyer, "substantially enhances the value of the company and bodes well for AMCC and its shareholders."

Really? It's hard to see how. Some of the company's changes, such as requiring a shareholder vote to reprice options, are already required by NASDAQ. Others were modest improvements at best. For instance, NASDAQ requires "independent oversight" of pay decisions; the settlement calls for the company to maintain its already completely independent compensation committee. Still other provisions, such as naming a lead director to coordinate meetings of independent board members, were already in the works, according to CEO David L. Rickey. Richard A. Bennett, a governance expert who helped craft the Applied Micro settlement, counters that several provisions, such as splitting the roles of chairman and CEO, are real advances. Still, shareholders didn't get a dime, though a separate class action is still pending. Company officials, meanwhile, denied the allegations in the lawsuit, which included artificially inflating the stock price and engaging in insider trading.

It is just another example of how there's as much bluster as big bucks behind the recent wave of such "therapeutic" shareholder deals. Governance experts and the lawyers who push the lawsuits laud them

for forcing boards closer to true independence and pressuring executives to be more accountable. But while some financial payouts have been impressive, the governance changes, with few exceptions, have not. Worse, the settlements are taking some of the pressure off companies to make more substantive changes. Even the appearance of shareholder involvement is mostly a technicality—rather than being agreed on by shareholders, these deals get hammered out by a handful of lawyers behind closed doors. Says Henry T.C. Hu, professor of corporate and securities law at the University of Texas School of Law: "I don't think this is a particularly good mechanism for dealing with flaws in corporate governance."

Whacking management

DRIVING THE RECENT spate of therapeutic settlements are two key facts: the desire of companies to put their legal problems behind them and the desire of plaintiffs' lawyers to make their clients happy. Shareholder lawsuits have long been the bane of public companies that get in trouble and see their shares plummet. The explosion of accounting scandals and executive-pay abuses in recent years gave the handful of law firms that specialize in these suits, such as Lerach Coughlin Stoia Geller Rudman & Robbins, yet another hammer with which to whack management. Their routines are much the

same: identify companies mired in controversy, locate institutional investors to serve as lead plaintiffs, and file a suit. Even if the case never makes it to court, some companies pay up just to avoid bad press and lengthy legal battles. But whereas the old-fashioned investor suits demanded just restitution for shareholders, the new cases seek both money and governance protections—giving the lawyers the kind of shareholder-friendly track record they need to snare lead plaintiffs in future cases. Companies are all too eager to agree.

To be sure, some of the resulting payouts are impressive: Cendant Corp.'s 1998 settlement netted shareholders a staggering \$3.3 billion. The plaintiffs' lawyers also did just fine, thank you, receiving \$55 million. The Honeywell International Inc. and Hanover Compres-



sor Co. settlements earlier this year paid out \$100 million and \$80 million, respectively, to shareholders, including millions for the plaintiffs' lawyers. Some of the governance changes attached to these big cases actually were worthwhile, too. At HealthSouth Corp., the law firm of Grant & Eisenhofer succeeded in removing five longtime directors on whose watch ousted CEO Richard M. Scrushy allegedly engineered a \$2.7 billion accounting fraud, which Scrushy denies. Broadcom Corp. and Hanover Compressor put shareholder-nominated directors on their boards—a notable advance that comes

Too often, the “therapy” ratifies existing changes

as business interests fight a similar proposal at the Securities & Exchange Commission.

But in many other cases, the “therapy” is simply window dressing to make management look like it has cleaned up its act.

In July, as part of a \$90 million settlement, FirstEnergy Corp. agreed to split the roles of chairman and CEO; it had already done so six months earlier. It also agreed to maintain a board with two-thirds independent directors—which is hardly a problem, since there's only one insider on its 14-member board now.

Honeywell's settlement requires executives to retain the bulk of the stock they acquire via options for one year—a major change. But it also requires the audit committee to approve consulting work performed by the external auditor—language lifted almost verbatim out of the two-year-old Sarbanes-Oxley Act. Says Peter H. Mixon, general counsel for the California Public Employees' Retirement System: “If a company is already required by law to enact certain corporate governance reforms, I'm not sure that including it in a settlement accomplishes much.”

Not unless you're a lawyer. By striking deals that look like a great result for shareholders, plaintiffs' attorneys get the kind of public-relations lift that money just can't buy, for an industry that's sometimes difficult to defend. But if lawyers truly want to protect shareholders, they should force companies to adopt real reforms. Anything less is a waste of time. ■

EYE-OPENER

Brian McGarvey (left) and Jennifer Chang (right) visiting a factory in Belize last year



It Takes a Village — And a Consultant

PricewaterhouseCoopers tests partners by sending them to work in poor nation

LAST SUMMER, ACCOUNTING-and-consulting giant PricewaterhouseCoopers tapped partner Tahir Ayub for a consulting gig unlike anything he had done before. His job: helping village leaders in the Namibian outback grapple with their community's growing AIDS crisis. Faced with language barriers, cultural differences, and scant access to electricity, Ayub, 39, and two colleagues had to scrap their PowerPoint presentations in favor of a more low-tech approach: face-to-face discussion. The village chiefs learned that they needed to garner community support for programs to combat the disease, and Ayub learned an

important lesson as well: Technology always the answer. “You better put your beliefs and biases to one side and figure out new ways to look at things,” he says.

Ayub may never encounter as extreme a cultural disconnect at PwC as he did in Namibia. But for the next generation of partners, overcoming barriers and forging a connection with clients the world over will be a crucial part of their job.

PwC says it is readying execs for the rigors of running a global firm

It's those skills that PwC hopes to foster in partners who take part in the Ulysses Program, which sends top mid-career talent to the developing world for eight-week service projects. For a fairly modest investment—\$15,000 per person, plus salaries—Ulysses both tests and expands

worldview of the accounting firm's future leaders. Since the company started the program four years ago, it has attracted the attention of Johnson & Johnson, Cisco Systems, and other big companies considering their own programs.

While results are hard to quantify, PwC is convinced that the program works. All 40 dozen graduates are still working at the company. Half of them have been promoted, and most have new responsibilities. Just as important, all 24 people say they have a stronger commitment to PwC—in part because of the commitment the firm made to them and in part because of their new vision of the firm's values. Says Global Managing Partner Willem Bröcker: "We get better partners from this exercise."

The Ulysses Program is PwC's answer to one of the biggest challenges confronting professional services companies: identifying and training up-and-coming leaders who can find unconventional answers to intractable problems. By tradition and necessity, new PwC leaders are nurtured from within. But with 8,000 partners, identifying those with the necessary business savvy and relationship-building skills isn't easy. Just as the program gives partners a new view of PwC, it also gives PwC a new view of them, particularly their ability to hold up under pressure.

For mid-career partners who were reared on e-mail and the BlackBerry, this is no walk in the park. They had become accustomed to a world of wireless phones, sleek offices, and Chinese takeout—so the rigors of the developing world came as quite a shock. Brian P. McCann, 37, a mergers and acquisitions expert from PwC's Boston office, had never been to a Third World country before his stint in Belize, where he encountered dirt-floored houses, sick children, and grinding poverty.

Ayub, having been born in Africa, considered himself worldly. Even so, long days spent among Africa's exploding HIV-positive population took their psychological toll. With his work confined to daylight hours—there was often no electricity—Dinu Bumbacea, a 37-year-old partner in PwC's Romanian office who spent time in Zambia working with an agricultural center, had plenty of time to dwell on the misery all around him. "Africa is poor, and we all know that," says Bumbacea. "But until you go there, you don't understand how poor it is. We take so much for granted."

For more than 15 years, companies have used social-responsibility initiatives to develop leaders. But PwC takes the

concept to a new level. Participants spend eight weeks in developing countries lending their business skills to local aid groups—from an ecotourism collective in Belize to small organic farmers in Zambia to AIDS groups in Namibia. Ulysses also presents participants with the challenge of collaborating across cultures with local clients as well as with PwC colleagues from other global regions. Ayub, for example, was paired with partners from Mexico and the Netherlands.

BEYOND ACCOUNTING

PWC SAYS THE PROGRAM, now in its third cycle, gives participants a broad, international perspective that's crucial for a company that does business

around the world. Traditional executive education programs turn out men and women who have specific job skills but little familiarity with issues outside their narrow specialty, according to Douglas Ready, director of the International Consortium for Executive Development Research. PwC says Ulysses helps prepare participants for challenges that go beyond the strict confines of accounting or consulting and instills values such as community involvement that are fundamental to its corporate culture.

Ulysses is also a chance for partners to learn what they can accomplish without their usual resources to lean on. The program forces them to take on projects well outside their expertise. In the summer of 2003, for example, McCann developed a business plan for an ecotourism group in Belize. The experience was an eye-opener. McCann's most lasting memory is a dinner he shared in the home of a Mayan farmer after they spent a day discussing their plan. "He didn't even have electricity," McCann recalls, "but he made do."

PwC partners say they've already adapted their experiences to the task of managing people and clients. Malaysian partner Jennifer Chang says her team noticed a shift in her managerial style after the Belize trip. She listened more and became more flexible. "Once you see how slowly decisions are made in other places, you gain patience for the people you work with," she says. Ayub, who was promoted in June, now manages 20 partners. He says he favors face-to-face conversations over e-mail because the low-tech approach builds trust. "It made the difference in Namibia," he says.

If insights like those ripple out across the firm, Ulysses will be more than a voyage of personal discovery for a handful of partners. It could help build leaders capable of confronting the challenges of an increasingly global business. And that, says PwC, is the whole point. ■

—By Jessi Hempel, with Seth Forges, in New York



Giving the World a Lift

To build better leaders, PricewaterhouseCoopers' Ulysses Program sends partners to the developing world to help local aid groups.

PURPOSE To prepare partners for top leadership positions in 5 to 10 years. PwC hopes participants will hone their problem-solving skills and develop a more international outlook.

ACTIVITIES The program includes working with PwC colleagues from other global regions on ecotourism, organic farming, and AIDS awareness projects. Among other things, partners have helped local organizations create business plans.

SCOPE PwC sent 20 partners to 11 countries in 2004, up from nine partners and three countries in 2002. So far, 44 of PwC's 8,000 partners have completed the program.

COST PwC spends \$15,000 per participant for travel and other expenses, plus three months of salary. Each one spends eight weeks in country and two weeks in training and debriefing.

Putting a New Face on Janus

Steven Scheid is trying to revive the battered fund manager's fortunes

MOST OF THE COMPANIES at which Steven L. Scheid has worked have come to grief. Arthur Andersen & Co., where he started out as an accountant, flamed out years later. Allied Bankshares and First Interstate Bancorp, where he held the top finance jobs, were gobbled up by rivals: Allied after it stumbled in energy and real estate loans; First Interstate when it became the object of a hostile takeover. And now, Charles Schwab Corp., where the genial Scheid was a vice-chairman until 2002, is struggling. Bad signs for his latest employer, Janus Capital Group Inc.? Emphatically not, says the new CEO of the Denver mutual-fund company. Insists Scheid: "I'm very bullish on where we are."

But Scheid, a 51-year-old Kansan whose sunny optimism gives no hint of the disappointments that befell his employers, admits that Janus has a way to go to regain the investment world's confidence. "It takes a long time for perception to catch up with reality," he says.

The company's tech-heavy funds rode the Internet boom to dizzying heights, only to fall hard in the bust. Fund investors in droves started pulling money out because of poor performance—and kept up when the firm got tainted in the mutual-fund scandals. On Aug. 18, the company agreed with New York Attorney General Eliot Spitzer, the Securities & Exchange Commission, and other enforcers to pay \$226 million to settle allegations that Janus had permitted market timing in its funds by hedge fund Canary Capital Partners and others. Over the past year, Janus has moved to discourage such practices, by imposing redemption fees on short-term transactions and ensuring that funds are valued at the latest prices.

REPAIR WORK

SCHEID INSISTS that better times lie ahead. And since he became CEO on Apr. 20, he has hatched plans to usher them in. To woo back clients, he plans to launch a high-profile TV-and-print advertising campaign in September that will invoke the 35-year-old Janus tradition of in-depth investment analysis.

With the help of recently appointed Chief Investment Officer Gary D. Black, formerly chief investment officer at Goldman Sachs Asset Management's global equities business, he is adding seven analysts to the firm's corps of 36, including several to cover more foreign stocks.

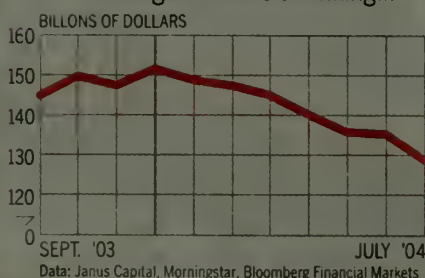
While promising to hew closely to the firm's growth-stock tradition, he is raising the number of companies his analysts cover from about 1,000 to 1,200, moving Janus well beyond tech—toward the likes of Procter & Gamble Co. and Starwood Hotels & Resorts Worldwide. And to drive home the message that results matter, he is tying portfolio managers' pay more closely to performance. He has also reshuffled management of the underperforming Janus Worldwide Fund, moving out Laurence Chang, designated successor to the well-respected Helen Young Hayes.

In hopes of delivering consistent long-term performance, Scheid is taking steps to ensure a solid mix of growth-oriented nontech stocks in the funds, avoiding the surfeit that damaged Janus in the Internet boom. And he has told portfolio managers to avoid loading up on the same stock, different funds and to make their funds distinctive. "Suitably diverse," he says, "mid-cap fund stays in the mid-space." Finally, he put the word out that underperforming managers wouldn't be around very long.

Scheid is also shaking off Janus' infamy. Unlike reclusive founder Thomas H. Bailey, who declined comment for this story, Scheid has reached out to cri-

SCHEID'S CHALLENGE

Janus' Assets under management are shrinking...

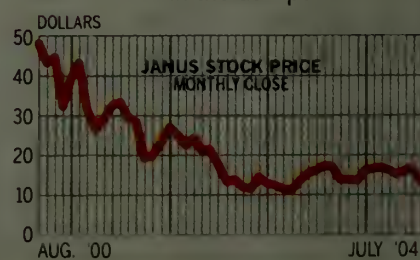


...and its funds are no longer star performers...

	JANUS*	S&P 500
7 months	-0.24%	0.02
1 year	13.40%	13.16
3 years	-1.67%	-1.48
5 years	-0.66%	-2.24

*Domestic equity funds annualized returns, through July 31

...keeping the stock in the dumps





SLOW SLOG
"It takes a long time for perception to catch up with reality," says Scheid

Scheid says his shareholders are "very long-term thinkers," but even they won't be eternally patient. Mutual-fund investors, shunning firms tainted by the market-timing scandals, have been sending their money to powerhouses such as Fidelity Investments and Vanguard Group. As they grow, a shrinking Janus may be hard put to stay independent.

MUSIC MASTER

BUT SCHEID IS NOT operating as if he's prepping Janus for sale. He's not cutting staff, but building Janus' operations, much as he helped expand Schwab in its heyday. There he helped preside over breakneck growth, aided by the '90s runup in tech stocks. But as CEO of Schwab's mutual-fund complex, he had to downsize anew once the bubble burst, and laid off some 2,500 staffers. "It was a very, very hard time," recalls Scheid. Friends say he left Schwab after the now-departed CEO David S. Pottruck wouldn't give him the autonomy he wanted. "Ancient history," says Scheid.

Scheid had already retired when the Janus board tapped him. Although he was in the market for a new challenge, he says, wine collecting, running, and enjoying his houses in Northern California and Arizona were the main items on his agenda. With three children in their 20s, the longtime piano and clarinet enthusiast—who attended Michigan State University on a music scholarship before switching to accounting—thought he

would be free to indulge such passions as supporting chamber music.

Now the question is whether Scheid can orchestrate a winning score for Janus. Besides shareholders and fund investors, there's a big potential payoff for him. Soon after he took the job, he suggested—and the board agreed—to pay him a third less than his predecessor and shift more of his compensation into stock options. ■

—By Joseph Weber in Denver

How to Fix Janus

What the tarnished firm needs to do to restore its reputation:

- ☒ Purge top execs
- ☒ Appoint new CEO and CIO
- ☒ Settle with regulators
- ☐ Beef up analyst ranks
- ☐ Widen investments beyond tech
- ☐ Boost fund returns
- ☒ Become more open to shareholders and critics

Data: BusinessWeek

analysts. For instance, he flew recently to Chicago to mend fences with Morningstar. Scheid's immediate predecessor, Mark Whiston, had lambasted the fund-cking firm for "recklessness and irresponsibility" last fall when it urged investors to consider selling Janus funds after Attorney General Spitzer made his allegations. Scheid, says Morningstar Managing Director Don Phillips, is "doing a terrific job."

Wall Street mavens echo those sentiments. CIBC World Markets Corp. analyst John Worthington, for instance, says Scheid and his managers are "making all the right moves." And yet, along with most analysts, he remains cool on Janus' underpriced stock. Nine analysts rate it a hold, four a sell, and none a buy. No wonder the stock trades near 14, a quarter of its 2000 peak in the fall of 2000.

Worthington wants to see an end to the outflows from Janus' funds before he gets bullish, but he fears it may take until 2006 to lure institutional money managers and financial advisers back into the fold. "Fixing [Janus] may just be a matter of a lot of time passing," says Peter F.

Lengsfeld, a financial consultant at the Denver area Presidential Brokerage Inc. For now, he's steering clients away from Janus.

Things are improving. Thirteen Janus funds have posted gains brisk enough to rank in the top quarter of their peer groups over the year ending June 30. But the firm's lingering legal and post-bubble baggage, coupled with the departures of a few high-profile execs and portfolio managers, such as Hayes, and earlier, chief investment officer James P. Craig III, seem likely to prolong its turnaround. With \$129 billion in assets under management, Janus is well below its all-time high of \$310 billion in March, 2000. And it is still hemorrhaging, with monthly net outflows running at \$1.1 billion—the July figure—or more. ING U.S. Financial Services, a longtime client, rattled Janus in July by saying it would pull out \$5 billion by yearend.

BusinessWeek online For an interview with Janus Capital CEO Steven L. Scheid, go to www.businessweek.com/magazine/extra.htm

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Conseco Wants Its Pound of Flesh

The company says former execs owe it millions, and it's battling them in court

IN THE LATE '90S, ONE JOKE IN the state of cornfields and race cars went: "Don't bother trying to win the Indiana State lottery, just angle for a top job at Conseco." These days, no one is laughing. A year after emerging from bankruptcy, a newly reconstructed Conseco is seeking to recoup \$650 million from the "Big Nine," a group of former directors, officers, and key employees. In flusher times, says Conseco Inc., it guaranteed bank loans so the brass could buy the company's once-soaring stock. And now it wants the money back. Such directors and officers (D&O) programs were outlawed in 2002 by the Sarbanes-Oxley Act.

It's not as if Conseco doesn't have other problems. On Aug. 12, its third chief executive in four years, William J. Shea,

abruptly resigned. He leaves with a parting gift of \$13.5 million in severance—an amount that forced the company to lower its 2004 earnings estimate, drawing boos from corporate governance champs. And on Aug. 9, Conseco announced a settlement with the Securities & Exchange Commission and New York Attorney General Eliot Spitzer over allegations that it allowed market timing by investors in its variable annuities. The company must pony up a \$5 million fine, though it didn't admit or deny guilt. No surprise that its shares are in the tank, recently hitting a 52-week low of 15.40.

Still, Conseco is in hot

LIVING LARGE
Ex-CEO Hilbert with his wife, Tomisue, in 2003

pursuit of the "Big Nine." And it's a doozy of a fight. In late 2003, in

U.S. District Court for the Southern District of Indiana and a U.S. bankruptcy court in Chicago, nine former honchos who took part in the D&O program and allegedly owe the company money. Several filed countersuits used to be the "Big 11," but Conseco former president and Chief Operating Officer, Thomas J. Kilian, settled on Aug. 12. The company says another former director is in the process of settling.) Rod Oslan, a lawyer for Conseco, says that the nine "have taken desperate measures in an effort to hide assets from Conseco."

FERRARIS AND RACEHORSES

CONSIDER STEPHEN C. HILBERT, a 58-year-old former insurance and encyclopedia salesman who founded Coleco in 1979. According to Conseco lawyers, he owes the most: in excess of \$220 million. Hilbert was chief executive until he stepped down in April, 2000, largely because the \$6 billion acquisition of Tree Financial Corp., a failing mortgage lender, had put Conseco on shaky financial grounds.

During his tenure as CEO, Hilbert built a reputation for living large: He bought baronial estates, Ferraris, racehorses and French antiques and ponied up millions to local Indianapolis charities. About four years ago, he began shifting almost all of his assets to his sixth child, Tomisue, 33, a former exotic dancer. She has also put money into trusts for her children, according to court documents. Conseco attorneys are seeking to invalidate the transfers, alleging they are fraudulent and that Hilbert made them to avoid repayment obligations. Says David Kleiman, Hilbert's lawyer: "Absolutely improper or fraudulent transfers have taken place."

People close to Conseco say that to justify Hilbert's transfer of his assets to Tomisue, he is portraying his wife as a

savvy businesswoman. David Kleiman says the allegation is "ludicrous." And a lawyer for Tomisue, Linda L. Kline, says that "Tomisue has been a very smart, astute businesswoman for some time." Tomisue recently announced she is launching a clothing and accessories line featuring images of dead icons as Marilyn Monroe and James Dean.

It's a doozy of a fight: Several former honchos filed countersuits

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USA
NETWORK

Friday, September 3
5-7 p.m. USA
Saturday, September 4
3-6 p.m. USA

abc SPORTS

Sunday, September 5
5-7 p.m. ABC
Monday, September 6
3-6 p.m. ABC

Web site has trumpeted: "From the likes of Donald Trump and Melania Knauss to HRH Prince Michael of Kent, Tomisue has been told that she has a gift that can only be described as style."

HOUSE-RICH

CONSECO IS NOW hitting up Hilbert for his house. The company holds the \$19.4 million mortgage on his 22,000-square-foot Carmel (Ind.) estate, "Le Château Renaissance," which features foyer murals depicting the courtship of Mark Antony and Cleopatra. Consecro is trying to force it into foreclosure. On Sept. 21, an Indiana judge will decide on the matter. Says Kleiman: "We expect the judge will

(Anna Nicole Smith, a Hilbert pal, recently taped a segment of her reality-TV show there, remarking in a press release she was "enthralled by the home's ambience and style.")

For his part, Hilbert contends he owes Consecro nothing. In court documents and according to Kleiman, he has asserted that Consecro's bankruptcy filing constituted a "change of control" of the company, entitling him to a cancellation of his debts.

Consecro is also gunning for the assets

Hilbert says he owes nothing. Consecro wants his house

Canaan, Conn.) to pay \$10 million for a 12,300-square-foot mansion near Miar Beach on a 0.49-acre site. Under Florida's homestead law, homes on up to half-acre plots and occupied as a principal residence are fully shielded from creditors.

In July, a district court judge in Indiana partly ruled against the Cuneos, saying that the couple's explanation

for suddenly moving to Florida—to be near her aging mother—was bogus, since her mother lives 120 miles from Miar Beach. He also found that the couple had no intention of residing permanently in the house. Consecro is now pursuing the case in the Sunshine State. Says Oslan: "It's blatant what the Cuneos are doing. The house costs \$400,000 a year in tax and upkeep alone, and they claimed court they make just \$400,000 a year." Cuneo's lawyer declined to comment.

Meantime, Rollin M. Dick, Consecro's former chief financial officer, is on the hook for \$70 million resulting from his stock loans. In court documents, Consecro claims he has continually and fraudulently transferred "tens of millions of dollars" to his wife and children over the past few years. The company says in 1998, Dick and his wife claimed they had a net worth of \$121 million, with \$37 million in mutual funds in Dick's name alone. By 2000, Dick's net worth had dwindled to a negative \$8 million. Kleiman, who also represents Dick, says that as with Hilbert, "This is improper or fraudulent transfers to place." Meanwhile, Dick faces other issues. In March, the SEC found that he and former Treasurer James S. Adams orchestrated a fraudulent accounting scheme at Consecro. As part of a settlement with the SEC, Consecro did not admit or deny the findings on behalf of Dick or Adams. Dick is also a subject of a criminal investigation by the Justice Dept. on similar matters. Kleiman declined to comment.

As for the remaining former executives and their stock loans, Consecro continues to duke it out with them. It remains to be seen how much Consecro will be able to collect. In a recent filing, the company has ratcheted down its forecast of how much it might recover, to just \$51 million, net of collection costs, though Oslan says he believes the figure will be "in excess of \$100 million." Meanwhile, the story keeps unraveling like a farce staged at Indianapolis' Hilbert Circle Theater. ■

—By Marcia Vickrey
in New York



Dunning the Boss

Consecro says founder and former CEO Stephen Hilbert owes it \$220 million, which he denies. The company is trying to recoup the money from assets, many held in the names of his wife and children. They include:

Le Château Renaissance, (above)	Mansion in the Caribbean's St. Martin	Art, antiques, and furniture	String of Thoroughbred racehorses	Interest in private company
\$20 Million	\$15 Million	\$10 Million	\$6 Million	\$20 Million

Data: BusinessWeek estimates

deny [the action] and that the case will go to trial next year." At least the Hilberts have another domicile in case they're suddenly homeless in the Hoosier state: an 18,500-square-foot oceanfront estate in the Caribbean's St. Martin, "Les Châteaux des Palmiers." The pad rents for \$90,000 a week and comes with seven housekeepers, four gardeners, a chef, an electrician, and an estate manager who has worked with the "Secret Service providing security for dignitaries," says an advertisement.

of former exec and director Ngaire E. Cuneo—named by *Working Woman* magazine as the nation's fourth-best-paid female executive in 1997—to repay \$60 million it alleges she owes in stock loans and interest. Consecro lawyers say that for Cuneo, home isn't just where the heart is, it's where the dough is. In May, according to court documents, Cuneo and her husband used the bulk of their assets (\$8 million from selling securities and \$2.4 million borrowed on their home in New

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The End Game At Lazard

Head Wasserstein wants to sell the firm. But first he has to buy out the boss

BRUCE WASSERSTEIN HAS always been a shrewd negotiator. The Wall Street legend built his career out of making big deals happen. Whether he was advising Kohlberg Kravis Roberts & Co. on its \$30 billion purchase of RJR Nabisco in 1989 or selling his own firm to Dresdner Bank for \$1.4 billion in 2000 and pocketing hundreds of millions, Wasserstein always came out on top.

Now, Wasserstein is at it again. As head of one of the world's last prestigious investment banks still in private hands, Lazard LLC, he has asked Goldman Sachs to take Lazard public. Meantime, he has talked for months to Lehman Brothers Inc. and other banks about buying Lazard, say sources close to the discussions. Through a Lazard spokesman, Wasserstein declined to comment.

Pulling off a deal for Lazard will be one of Wasserstein's trickiest feats yet. Before he can move, he needs the nod from Chairman Michel David-Weill, 71, scion of the firm's founding family. Wasserstein, 56, has been at loggerheads with David-Weill practically ever since the chairman hired him to run Lazard in 2001. Worse, the firm's opaque accounting and labyrinthine share structure are scaring off some potential buyers

while driving down Lazard's price.

BusinessWeek has learned that David-Weill is considering permitting an initial public offering to happen, but only if Wasserstein buys him out first—and at a handsome price. He wants to get roughly the same valuation for his shares as British publishing conglomerate Pearson PLC received when it sold its 18% stake in Lazard for \$724 million in 1998—valuing the firm at \$4 billion. Lazard's other non-working partners, such as investment company Eurazeo, want the same deal. Together, they own 36% of Lazard and

Putting the House Of **Lazard** in Order

The venerable private bank is mulling an IPO. But before it can go public, it needs to:

OBTAIN approval from Chairman Michel David-Weill, who can veto any deal.

CLARIFY accounting. David-Weill says the firm is losing money; head Bruce Wasserstein maintains it's profitable.

SIMPLIFY an ownership structure that gives limited, general, and working partners different rights to profits.

Data by BusinessWeek

ARCH RIVALS
David-Weill has long clashed with Wasserstein on strategy

have six of its 11 board seats. If Wasserstein doesn't play ball, they would use their six votes against Wasserstein, who can muster five, to block any IPO. "If Michel gets the money, he'll go," says a senior working partner. "But he's asking what not a reasonable price." David-Weill declined to comment.

The dollar signs dancing in Wasserstein's head are even bigger. He thinks Lazard should be priced at \$6 billion overall in an IPO or sale, according to people who talked with him. Bankers say \$3 billion is more realistic. They believe Lazard has lost money since Wasserstein started doling out multimillion-dollar contracts to hire dozens of hotshot bankers. Wasserstein said he needed to re-invest in the firm for two years to turn it around. Also, the IPO market looks rocky since boutique investment bank Greenhill & Co. made a big splash going public in May.

AGAINST THE CLOCK

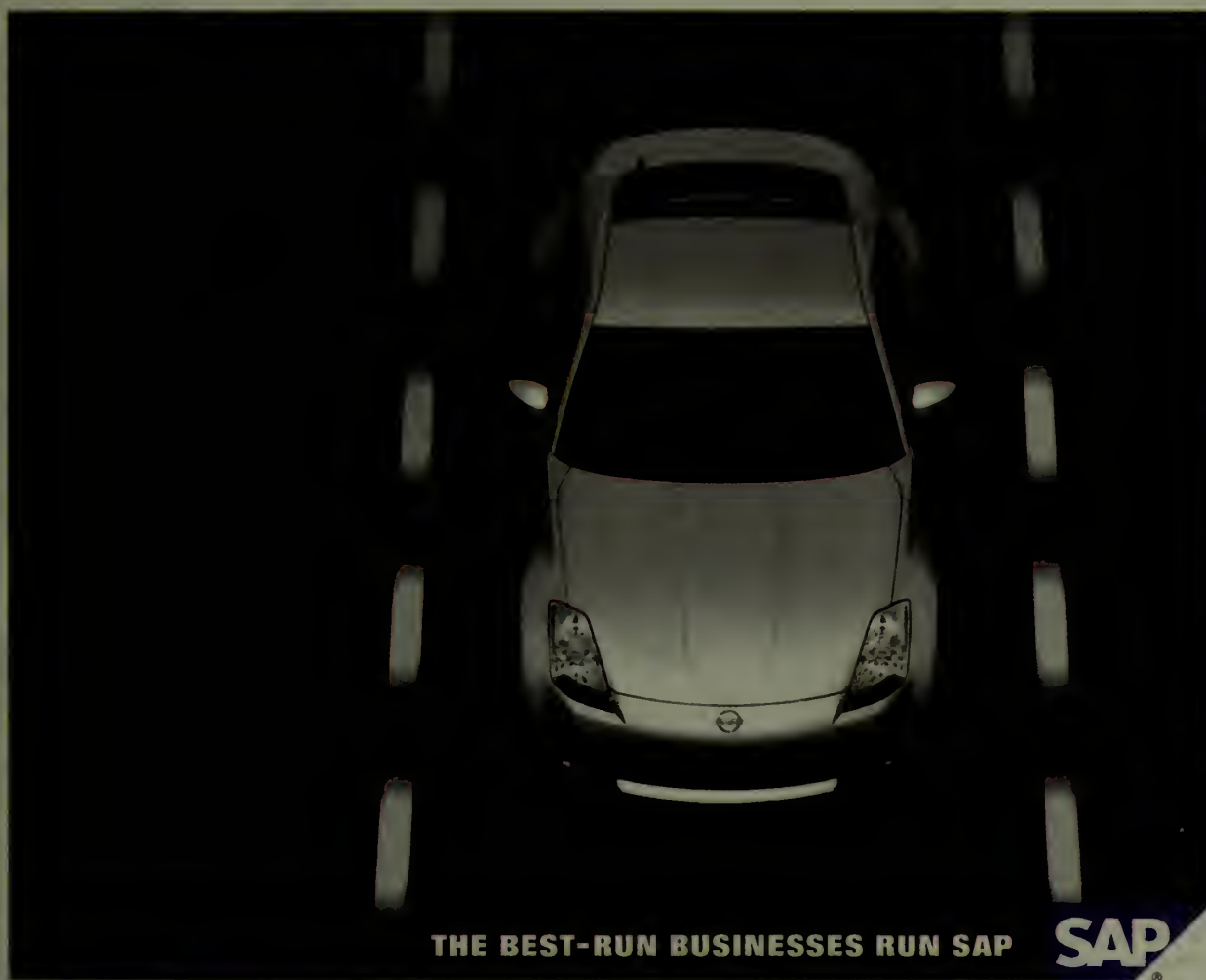
WASSERSTEIN HAS a great incentive to move a deal along quickly. David-Weill can kick him out in 2006, when his contract ends. But if Wasserstein takes the firm public before then, and buys out his partners, he'll basically control it. "This is a high-stakes, three-dimensional chess game being played between these two men," says William D. Cohan, a former Lazard banker writing a book.

Even if Wasserstein agrees to David-Weill's terms, he still has a lot of work to do. For starters, he needs to clarify the firm's accounting. Wasserstein maintains, and Lazard reported, that it earned \$249 million in 2003; David-Weill complains it lost \$150 million. The difference is likely that Wasserstein doesn't include his partners' "distributions," which are primarily compensation, in his calculation. But it's hard to be sure: Lazard doesn't disclose how much it pays its partners.

Wasserstein also has to clear the corporate cobwebs spun during Lazard's 156-year history. For example, the firm has a complex structure that pays limited, general, and nonworking partners differing shares of profits. Still, it's way too early to bet against Bid 'Em Up Bruce. On the whole, the cards have been dealt far—and the flop is sure to bring some big surprises. ■

—By Emily Thornton in New York and John Rossant in Paris

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COMMENTARY

BY CATHERINE YANG

Behind in Broadband

New policies are needed to help the U.S. catch up

LOVE. TEARS. ROMANCE. LIKE millions of other Japanese, Midori Kato has been transfixed by the Korean soap opera *Winter Sonata*. But the 42-year-old freelance editor started watching the weekly drama even before it became available on broadcast television in April. Instead of watching on her TV, she logged on to the Web over a blazing 100-megabit-per-second broadband link. The video is just as crisp as her TV screen, right down to the tears on heroine Choi Ji Woo's cheeks. "I'm hooked," Kato says.

Don't expect to share in the travails of *Winter Sonata*'s lovers anytime soon. That's because the U.S. is becoming something of a broadband backwater, a place where almost no one can do what Kato and millions of other Japanese take for granted. Many Americans may think that the U.S. is making progress because the number of broadband Net links continues to climb, but that misses the bigger picture.

The U.S. has steadily fallen behind other nations, both in terms of the share of the population with broadband and the speed of those connections. Consider this: In 2000 the U.S. ranked third in broadband penetration among the nations in the Organization for Economic Cooperation & Development. Last year it dropped to 10th place. That's behind recognized leaders such as Japan and Korea, as well as countries like Belgium and Canada. "It's ridiculous that the U.S., of all places, is so far behind in this key measure of economic development," says Tim Johnson, publisher of London's *Point Topic*, which analyzes world broadband trends.

At stake are more than just the bragging rights. Broadband is the foundation upon which entire new generations of technology will be built: full-motion video, Web-based medical care, more sophisticated Internet telephoning, and on-line gaming. Already, companies abroad seem to be using their robust broadband markets to gain an edge on U.S. rivals.

Korea's NCsoft Corp. has come out of nowhere to become a tough contender in multiplayer online games. The *City of Heroes* game it launched this year has become one of the most successful online games in the U.S., while competitor Electronic Arts is struggling to create a multiplayer hit. "Given its experience in Korea, NCsoft may have an edge," says analyst Joseph Laszlo of Jupiter Research.

That's why the U.S. is in dire need of stronger leadership in broadband. The country is alone among developed nations in not having a comprehensive broadband plan. Both President George W. Bush and Democratic Presidential candidate John F. Kerry have pledged to tackle the issue after the election. But so far, their proposals, such as refraining from taxing con-

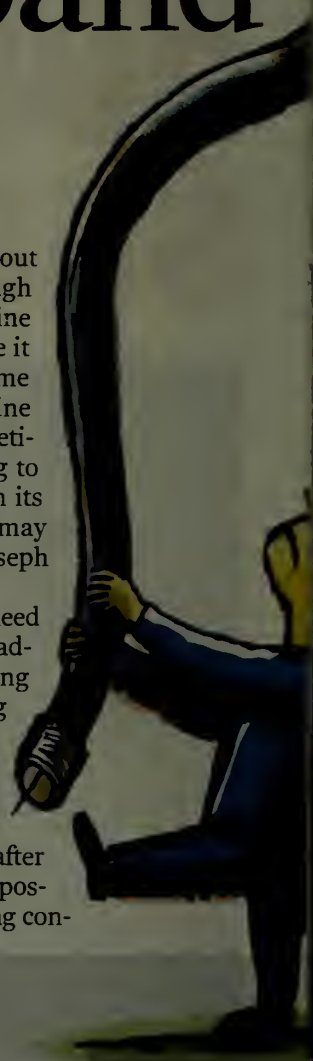
Taking a Wrong Turn On Broadband

In 2000, America had the world's third-highest broadband adoption rate. Now it's No. 10—and could slump further in the years ahead. Here's why:

NO LEADERSHIP: While nations such as Canada, Japan, and Korea adopted policies to promote broadband years ago, no U.S. Administration has yet endorsed a comprehensive plan. President George W. Bush and Democratic Presidential candidate John F. Kerry are advancing broadband plans, but the initiatives are modes

BOTCHED PUBLIC POLICY: The U.S. has never had aggressive pro-broadband policies, and it's now moving backward. This year, U.S. regulators dialed back on the Bells' obligation to lease their networks to competitors at deep discounts. That decision will eliminate AT&T and other companies as viable broadband players.

TIMID COMPETITION: U.S. consumers depend primarily on a cozy duopoly of broadband providers: the Bells and the cable-TV companies. The two sides have been slow to push for higher broadband speeds or fast price declines.





Congress should not let TV outlets hog the best space in the spectrum

mer Web-access services, are modest. Worse, current U. S. policies have the country moving backward. Look closely at the evidence: What helped the rollout of broadband in Korea and Japan were not massive government subsidies, as some believe, but policies that allowed vigorous competition. In particular, those countries forced the incumbent phone companies to let startups use their networks at reasonable, government-set prices. Those startups, especially Hapro in Korea and Yahoo! BB in Japan, waged fierce battles against giant rivals, driving prices down and speeds up. "Competition is the No. 1 [reason] why one country grows faster than another," says Sam Paltridge, the OECD's telecom analyst.

On this score, the U.S. has blown it. This summer the Bells won an eight-year battle to stop competitors from using their networks at deep discounts. That prompted AT&T and MCI Inc., which had been using the Bells' lines, to retreat from the consumer markets. "The holy *jihad* war of telecom between the incumbents and the competitors" has delayed broadband in the U.S., says former U.S. Federal Communications Commission

Chairman William E. Kennard, who favored the Bells' leasing obligations. Now, most markets are cozy duopolies, at best, where consumers can get broadband only from a phone or cable company. The result is that U.S. consumers can pay \$35 or more for a 1.5-megabit-per-second connection, compared with Yahoo! BB's price of \$25 for 26 megabits.

To have any hope of joining the world's broadband vanguard, the U.S. must create a viable third competitor. The options are few. Congress is unlikely to force politically powerful Bells to share their networks, even though lawmakers are expected to rewrite the telecom industry's regulations next year.

Much more promising is the rivalry that might be sparked by new, inexpensive wireless technologies. Chief among these is WiMax, expected to be available next year. WiMax is expected to zip bits through the airwaves as fast as 75 megabits per second and cover areas as wide as 30 miles. Because the equipment needed to cover a small city can cost as little as \$100,000, WiMax could open the door to a stampede of contenders. Already, it's winning the backing from the likes of chip giant Intel Corp. and cellular pioneer Craig O. McCaw.

Bush and Kerry both favor making airwaves available for the new technologies, but there's one hitch: The best radio spectrum for wireless broadband isn't available. It's being used by TV broadcasters for analog transmissions. The broadcasters have been given another set of airwaves, for digital TV, but they're not eager to forfeit their freebie. If Bush and Kerry want wireless technology to spark more competition, they'll have to make the politically difficult step of taking on the powerful broadcasters.

Rural Reach

FEDERAL AND STATE governments can provide other incentives to create a third rival. One way is for lawmakers to pass a bill now pending, sponsored by Senators John D. Rockefeller IV (D-W.Va.) and Olympia J. Snowe (R-Me.), to let companies expense equipment costs when they build networks of at least 20 megabits a second. A U.S.-backed bond program would encourage municipalities to build their own fiber networks and then lease them to startups. And government can attract broadband to sparsely populated regions without tax dollars by creating pools of local buyers—a measure Canada has adopted to reach its vast rural expanses. For instance, a U.S. Veterans Administration hospital, acting as an anchor tenant, could corral a group of local businesses and nonprofits to entice a phone, cable, or wireless company to serve them.

There are plenty of U.S. defenders who say the nation need not fret. After all, broadband is becoming more widely used. And the Bells are promising to build faster networks. Verizon Communications Inc. is spending billions to install fiber lines as fast as 30 megabits per second in 3 million households by the end of 2005. Plus, some argue that other countries have an advantage in broadband because their populations are more densely packed and therefore cheaper to reach.

But excuses never make good policy. If the U.S. is not to lose out in the global race for the next-generation Internet and the new businesses it can spawn, change is needed. The country must create vigorous competition to drive the low prices and high speeds that can usher in a prosperous broadband economy. ■

—With Moon Ihlwan in Seoul and Hiroko Tashiro in Tokyo

TILLY AND THE WALL

Low costs let indie bands break even at 10,000 albums



Kissing Off The Big Labels

Team Love has a new approach to selling its CDs: Give away free downloads

IT'S LATE AFTERNOON, AND A summer storm is pounding the lower Manhattan streets around the Italian café where Nate Krenkel sits. The shoulder of Krenkel's faded blue T-shirt is soaked from water dripping off the awning above him, but he's deep into the tale of how he started a new record label with Conor Oberst, founder of the indie band Bright Eyes. Instead of stopping to move inside, Krenkel tucks the CD he brought along under the breadbasket to

protect it and plows on. The decision to start Team Love, he explains, came about a year ago when the pair were in Omaha to celebrate Bright Eyes' selling 100,000 copies of its latest CD. "We wanted to start something new," he says. "We wanted it to be an artist-friendly label, but with the addition of some new policies."

The same weekend in Omaha, Krenkel and Oberst pitched their new approach to Tilly and the Wall, the band they wanted as their pioneer artist. Over plates of Thai food at a local restaurant, they explained

that the contract would be short, covering only one album, and that it would give the band plenty of recording freedom. Most unusual, when Team Love CDs were on sale, every song would be available free of charge online. "We thought downloading could be used as a promotional item," Krenkel says. "There's something exponential going on. The more music that's downloaded, the more it sells." Tilly and the Wall agreed. "It's a way to be part of what's happening today and not try to control it," says Jamie Williams (pictured above, wearing a necklace).

While the record industry has been waging war against the Net and music rates for years—arguing that such forces might destroy their business—a free crop of artists is taking the opposite approach. Team Love, Tilly, and many others are embracing technology and using it in innovative ways. And this, even more than illegal downloaders, has the potential to recast the industry. That's because the Net frees musicians from the need for major labels, allowing them to market themselves by giving away their music and to communicate with fans through message boards and blogs. "The Internet changes the dynamic," Oberst says.

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takes away the marketing advantage that the big labels have and gives people a chance to listen to music they couldn't hear on the radio or get in a Wal-Mart."

The birth of Tilly and the Wall online hints at the threat to the recording industry. Major labels typically need a band to sell at least 500,000 records to make a decent profit because of their high overhead. Efficient indie bands cut out the middlemen and can make a tidy living on 20,000 or 30,000 albums. Tilly and Team Love expect to break even at 10,000 CDs, a respectable number for an indie band's first album. With the online marketing, backed up by a tour, Tilly has sold 3,000 copies of *Wild Like Children* in the two months since the CD's release.

DIFFERENT DRUMMER

THAT CONJURES UP a totally different music world. There will always be the Britneys, Ushers, and Beyoncé's who can use the majors' deep pockets to sell millions of records and get rich. But smaller artists may be transformed into something other than castoffs and money losers. They have the opportunity to earn respectable sums without the burdens of the majors. Rather than destroying popular music, the Internet seems to be opening the door to a flowering of creativity. "The independent world has been energized," says Michael Hausman, who founded SuperEgo Records with Aimee Mann after the singer left Universal to release an album online in 1999.

If Team Love sounds like a bunch of

naive artists, think again. At 24, Oberst is an 11-year veteran of the music industry who developed a cult following when he shot into the spotlight with Bright Eyes. He and his brother helped start the record label Saddle Creek, a nexus of the Omaha indie scene. Krenkel worked for eight years at EMI and Sony, signing bands and songwriters. With their backgrounds, Oberst and Krenkel recognize that setting a precedent of free downloads may ruffle a few feathers in the music world. "We wanted to make a definitive statement that this is our policy, and we're not particularly interested in what people in the industry think," Krenkel explains.

Team Love lets the Net do what it does best: build grassroots awareness and create communities of like-minded people. In place of usual tactics, such as paying promoters to push for playtime on national radio and MTV, Team Love is melding its Internet-friendly strategy with sending out CDs to college radio and touring for its first two bands: Tilly and Willy Mason, a 19-year-old acoustic musician from Martha's Vineyard. It's also giving people who haven't seen Tilly on tour a glimpse of the band by posting a free video of Tilly's single *Reckless* online. The five-member band uses beguiling harmonies to tell tales of first loves, dancing, and summer nights. And rather than a drum-

mer, Williams keeps the beat by dancing onstage in shiny, silver tap shoes.

Their optimistic, anti-cool approach seems to resonate. Since the album's debut in June, around 250,000 free singles have been downloaded. At social networking services LiveJournal and Friendster, fans from Los Angeles to Gainesville, Fla., discuss the band, trade updates on upcoming shows, and arrange to meet one another at shows. They sometimes add videos of shows they've seen. "There's something about Tilly that really

stands out," says Chris Aquino, a 17-year-old high school senior in Chicago who posts on LiveJournal. He first heard about Tilly from a friend and downloaded their music free online before buying a CD.

Mason put up his own Web site nine months ago, although he admits he's a bit clueless about publishing online. He initially set up a message board by posting

his user name and password online for fans—which could have let visitors alt his site in any way they wanted. A fan from San Francisco came to his aid, offering to run the board. Now people from around the U.S. and Europe post notes online. Mason pops in occasionally to answer questions—such as when his album *Where the Humans Eat* is coming out (October).

Mason's upcoming CD is presenting Team Love with the first serious challenge to its Net-friendly policy. As the buzz about his music spread during the summer, Mason drew interest from several labels, including Virgin UK, to issue the album outside the U.S. But the company is balking at Team Love's free download policy. So instead of free songs, the label plans to put up demo outtakes, and early versions of Mason's songs when his CD is released. "First and foremost, we want to be a label that's good to our artists," says Oberst.

Team Love is trying to learn from that experience. It's laying out the potential problems more clearly to other artists it's trying to sign, including Dave Dondero. Still, Krenkel and Oberst have seen how the Net has helped build Tilly's popularity, and they're determined to use the technology to support other musicians they admire. An entire industry is watching. ■

—By Heather Green in New York

Rather than destroying pop music, the Net lets creativity flower

If You Can't Beat 'Em...

For Team Love, a new music label co-founded by Conor Oberst of the indie band Bright Eyes, the Internet is a friend, not a foe. Here's how the young label and its first two bands, Tilly and the Wall and Willy Mason, are using the Web to do things in a fresh style:

SAMPLING SONGS

OLD WAY Labels offer 30-second audio clips for some songs online and sue people who swap music on the Net.

NEW WAY Team Love offers songs free of charge, so people can hear the music before paying \$12 or so for a CD. Tilly's whole album was posted online when it premiered in June.

MARKETING

OLD WAY Labels push for playtime on MTV.

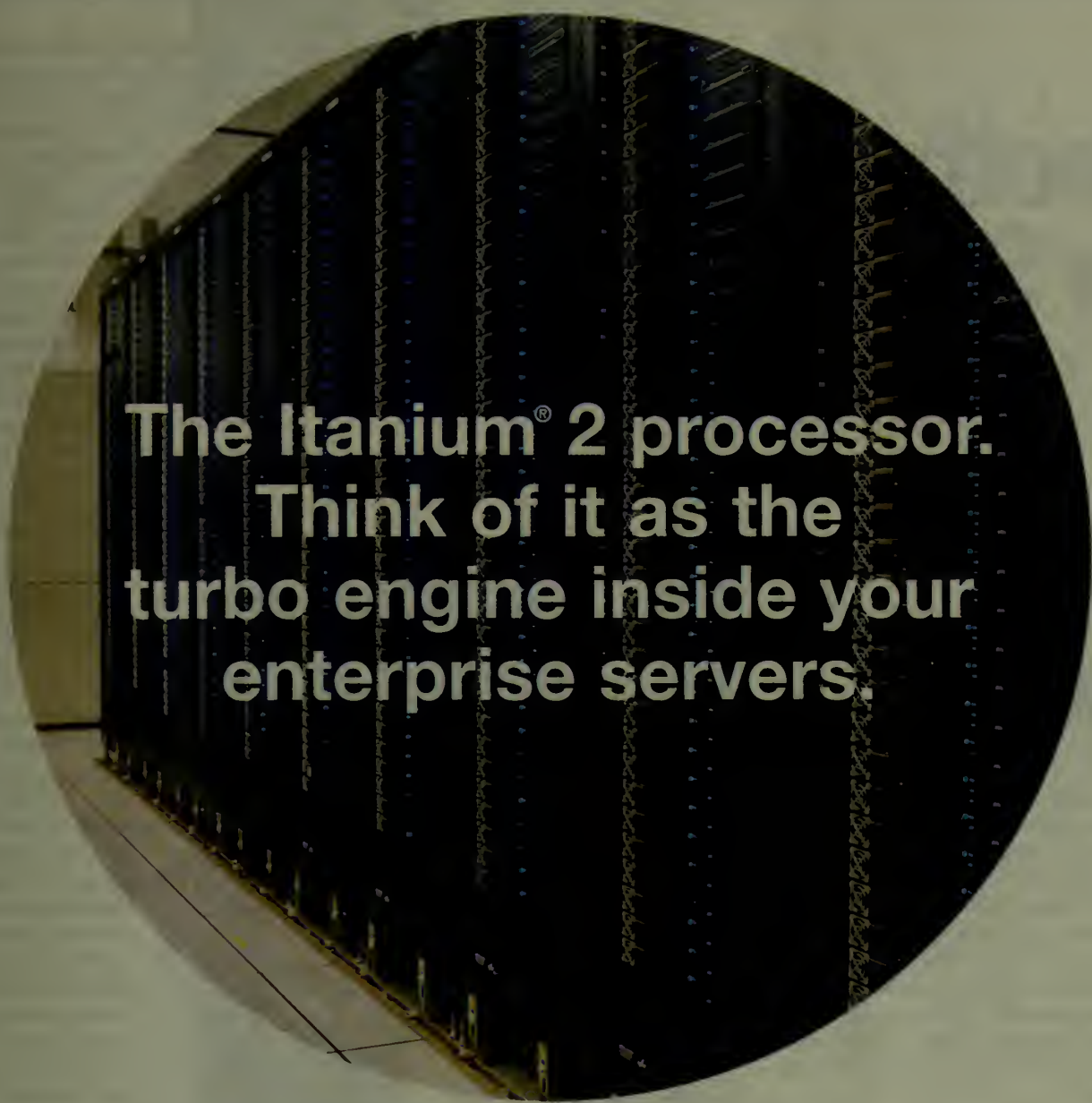
NEW WAY Team Love puts videos online that can be downloaded and shared. Tilly has sold 3,000 albums so far, well on the way to its goal of selling 10,000 CDs in the first year.

REACHING FANS

OLD WAY Labels use interviews in magazines, TV, and radio.

NEW WAY Team Love uses quirky Web sites. Willy Mason trades comments with fans on his site, using a message board that a fan offered to run for him.

BusinessWeek online For Q&As with Team Love's Krenkel and Oberst and Tilly fan Aquino, go to businessweek.com/magazine/extra.h



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Another Dawn for Solar Power

Tech breakthroughs and high energy prices are rekindling the industry

ON A SUNNY JUNE DAY in 1979, President Jimmy Carter held the first and only press conference on the White House roof. Atop the West Wing, he unveiled a \$28,000 solar cell system that captured the sun's energy to provide hot water for the White House. He also launched a sweeping drive aimed at harnessing the sun, the wind, and other renewable resources to generate 20% of America's electricity by 2000.

It didn't happen, of course. The share of electricity produced by solar cell technology in the U.S. last year was a mere 0.07%. Carter's solar water-heating system was removed in 1986 so a leak in the roof could be fixed. The solar panels were supposed to be reinstalled but they never were.

Now, several startups aim to revive Carter's dream of harvesting the sun's rays. Even the optimists admit it will take years to build enough solar energy capacity to make a dent in coal and natural-gas consumption. But with better technology, new solar systems could start plugging the power supply gap during periods of peak demand in some regions by 2007.

There are two basic concepts for tapping the sun's energy: collect its heat or convert its light. The solar-thermal approach uses mirrors to reflect the heat energy from a large area onto a small space, such as a pipe filled with a fluid like molten salt. Once the fluid's temperature has been raised to hundreds of degrees, it can be used to boil water and produce steam for a conventional generator.

With the other approach, called photovoltaics, a semiconductor—typically silicon—absorbs the photons streaming



HARD CELL A technician looks over solar panels at Boeing

from the sun and reacts by giving off a flow of electrons, or electricity.

HOT OVERSEAS

BOTH TECHNIQUES have been around for ages, but they have made little headway in the U.S. because of cheap fossil fuels. In Japan and Europe, where such fuels aren't so cheap, unit sales of solar energy systems have been mushrooming

35% annually since the mid-1990s. The combination of rising fuel costs and engineering advances that boost the efficiency of solar power systems are stimulating fresh U.S. investment.

The solar-thermal strategy is roughly 30% efficient at turning the sun's rays into electricity—about double the efficiency of photovoltaics. As a result, the thermal technique enjoys a pricing advantage. The giant solar-dish mirrors designed by Stirling Energy Systems could generate electricity for less than 10¢ per kilowatt hour (kwh)—maybe even less, asserts David J. Slawson, CEO and founder of the Phoenix startup. Unlike photovoltaic panels, though, solar dishes aren't practical for homes. To work effec-

tively, they need to be installed in large—too big to plan on fitting on a roof or even in a backyard. Stirling Energy's solar dishes are 38 feet across and 40 feet tall and generate 25 kilowatts, enough juice for five more homes.

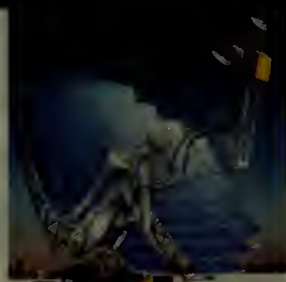
The dishes are based on technology pioneered at the Solar Two "factory" in California's Mojave Desert, sponsored by the Energy Dept. Mothballed in 1999, Solar Two uses 1,800 solar dishes in concentric arcs to reflect the sun's heat onto a central "power tower." That tower required a massive \$150 million investment for 10 megawatts of capacity—or \$15 per watt. To reduce costs with a modular approach, Slawson has scrapped the power tower. Instead, he mounts a miniature generator at the focal point of each dish.

When these power dishes enter volume production, expected around the end of 2006, Slawson predicts costs will tumble

90%, to \$25,000 per 25-kilowatt dish. That would put the capital cost of a 10-megawatt plant at \$10 million, or \$1 per watt. Arizona Public Service Co., which is under a state mandate to generate 1.1% of its electricity through renewable resources by 2007, isn't waiting. It will install 10 dishes next year. And utilities in Nevada and California are haggling for 40¢.

On the photovoltaics front, upstart

icx Inc. in Los Gatos, Calif., predicts that residential and commercial solar panels made with its silicon materials will soon compete with conventional fossil-fuel generators in markets where electricity costs at least 10¢ per kwh. But for that to happen, the capital cost of solar systems needs to reach the same magic number of \$1 per watt of generating capacity. That up-front investment, along with operating efficiency and equipment depreciation, determines the price at which kilowatt-hours of output can be sold. Today, the installed cost of high-efficiency silicon solar panels starts at \$3 per watt. Our customers should get \$1 a watt by 2007," declares Robert S. Erd, CEO of Solaicx. Around 2010, the Energy Dept. expects improved solar cells to generate electricity at 6¢ per kwh.



Power dishes like this one from Stirling can plug energy supply gaps

CHEAPER CELLS

SOLAICX WON'T BEGIN shipping silicon from its new factory until October, but Erd claims that two top producers of solar panels—he won't say which ones—have already signed up to buy the silicon wafers. So has SunPower Corp. in nearby Sunnyvale, Calif. A solar panel typically has 36 solar cells carved from compact-disk-size silicon wafers. Solaicx will turn out the wafers with equipment similar to that used to make raw silicon in the semiconductor industry—but tailored from scratch for high-volume production. "It's just good old-fashioned silicon done right," says John T. Sedgwick, founder of Solaicx.

Solaicx uses two tricks to produce better solar cells: make the silicon wafers 10% thinner and thus cheaper, and increase something called carrier lifetime. When photons from the sun hit the surface of a solar cell, they dislodge electrons from silicon atoms. The longer these electrons remain free—the carrier lifetime, measured in milliseconds—the greater the chance that they will stream off the solar cell "and into your toaster or lightbulb," says J. William Yerkes, chief technology officer of Solaicx and a photovoltaics pioneer for three decades.

With today's silicon, roughly 16 of every 100 bumped-off electrons make it into the real world, Yerkes says. That means the cells are 16% efficient at turning sunlight into electricity. By boosting

carrier lifetime, Solaicx' lower-cost wafers have yielded prototype solar cells that are 21% efficient.

Silicon-based solar cells represent 92% of today's photovoltaics market, but some producers are betting on different, much cheaper materials for the future. One is a conductive polymer salted with nano-size carbon molecules dubbed buckyballs. Last year, researchers at Germany's Siemens Solar Group (now Shell Solar) applied a very thin coating of the buckyball mixture on a plastic film and produced a solar cell that topped 5% efficiency—the best yet for an organic solar cell. The cost of

these solar cells would be a fraction that of their silicon cousins, so a homeowner could buy five or ten times the surface area and still save money.

Despite its modest cost, the low output may limit initial applications to fold-up recharging pads for laptop computers and other portable gadgets. But the researchers are confident that efficiency can be hiked to 7%, or perhaps 10%. Then the solar coating applied to a roof could supply all the required electricity to a home.

Turning rooftops into power plants is also a focus of newcomers on opposite coasts. Nanosys and Nanosolar, both in Palo Alto, Calif., and Konarka Technologies in Lowell, Mass., are developing liquid-plastic compounds that can be applied to most surfaces. But instead of buckyballs, they spice the mixture with nano-size semiconducting wires or pinheads called quantum dots.

Japanese giant Matsushita Electric Industrial Co. has teamed up with Nanosys to develop solar coatings that could be painted on roofs and walls. Commercial products are still a couple of years off. Konarka echoes that timetable for its solar roof technology, but recharging pads and solar energy coatings for Army tents could be ready next year.

A Midwest company,

Energy Conversion Devices Inc.'s United Solar Ovonic unit in Auburn Hills, Mich., grabbed the early lead in solar roofs. Since 1997, it has been applying silicon coatings on roofing materials. Its solar film can also be supplied as peel-and-stick rolls, and these will be used on the roof of Beijing New Capital Museum in China.

Thanks to the revolution in materials science wrought by nanotechnology and conducting plastics, organic solar coatings are also under development at such industrial stalwarts as General Electric Co. and IBM. And organic solar cells are the focus of a new 4.6 million euro, 30-month research effort in Europe. Called Molycell, its goal parallels what Solaicx and Stirling Energy promise: solar power systems with a capital cost of \$1 per watt. France's atomic energy agency heads the Molycell team. Konarka, Siemens, and a half-dozen universities and energy research centers are participating.

While the U.S. is still a major player in solar research, it has fallen behind in reaping profits from solar cells. Japan is way ahead of every other country. In 2001, its annual capacity was nearly four times that of America's 167.8 Mwp—the peak, or no cloudy days—and Germany was a solid No. 2, with 260.6 Mwp. Last year, Japan generated half of all the world's solar power, built 44% of all new solar energy equipment, and installed five times as much new solar power capacity as the U.S. One company, Sharp Corp., accounted for 27% of all new solar panels, according to market researcher PV Energy Systems Inc. in Warrenton, Va.

Worldwide, unit shipments of solar systems have jumped 35% or more for each of the last eight years. Include installation costs, and market researcher Clean Edge Inc. pegs solar industry sales at \$4.7 billion in 2003. For 2013, the Oakland (Calif.) company sees solar topping \$30.8 billion.

However, that projection is based on installed per-watt costs remaining way above \$1. If Solaicx, Stirling Energy, and Molycell deliver solar generation for \$1 a watt by 2007, the business of harnessing the sun's energy could go supernova. ■

—By Otis Port in New York

Who's Who in Solar Power

Japan's Sharp is king

MEGAWATTS OF CAPACITY SOLD IN 2003

1. Sharp	198
2. Shell Solar	77
3. Kyocera	72
4. BPSolar	70
5. RWE	42
6. Mitsubishi	40
7. Isofoton	35
8. Sanyo	35
9. Q-Cells	28
10. Photowatt	20

Data: PV Energy Systems Inc.

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These systems offer data integration with CRM and employee databases. They can interface with procurement and corporate travel guidelines, word processing and spreadsheet applications, and provide automated email communications, which all save time and improve consolidated reporting and analysis for more efficient meeting management.

Outsourcing the registration process to a solutions provider

still offers the ability to customize each event's look-and-feel and individual registration process. Plus, most providers offer the highest level of security, and advanced deployment options with alternatives in hosting and accessing the application and data.

Mature, robust registration solutions provided by outsourced providers deliver greater functionality and are ready to use from day one, without tying up internal IT resources, saving time and money from the outset.

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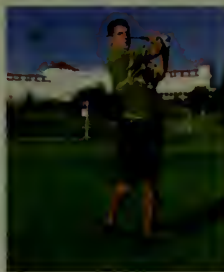
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The UCLA Conference Center is just 2 hours from Los Angeles and San Diego County, 1 hour from Ontario International Airport. Guests enjoy 310



days of sunshine and 4 distinct seasons where winter temperatures average 40-60°.

The facility has ten main conference rooms plus numerous breakout rooms as well as recreational facilities such as tennis courts, putting green, swimming pool, ropes course and acres of forest and shoreline

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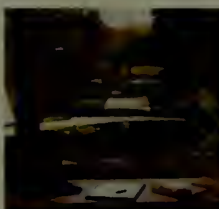


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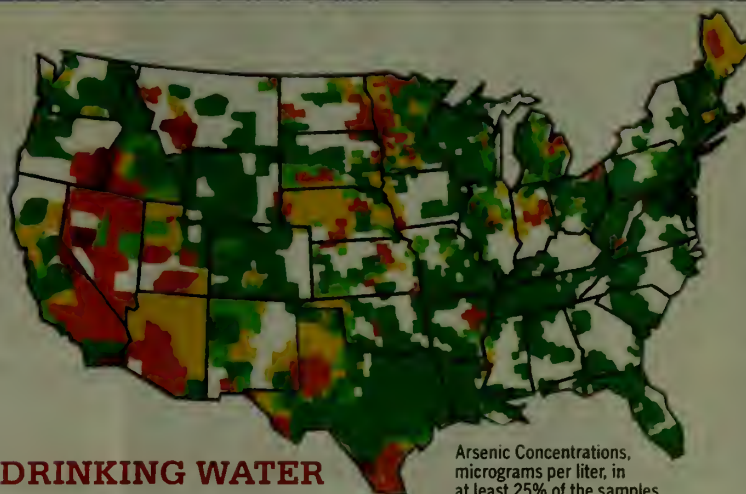
contemporary conference commons

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DAM ASTON

INNOVATIONS

Of crooked faces
and hormones

It's a finding that would ease physiognomists of the 1900s, who thought facial features revealed human character. Researchers at Ohio State University say that right-left asymmetries in body features can be a marker for aggressive tendencies. Studying fingers, ears, feet, etc., in 100 college students, they calculated an overall index of asymmetry. Students then endured a series of frustrating phone encounters. The most asymmetrical proved to be the most easily provoked. What's the connection? Writing in the July/August *American Journal of Human Biology*, the authors cite studies showing that stresses such as illness, alcohol use, or smoking during pregnancy can cause asymmetrical fetal development. That affects the central nervous system, which governs impulse control and aggression. Men who receive radiation for prostate cancer often take hormone blockers for up to three years afterward—with side effects that include hot flashes, impotence, impaired memory, and anemia. But a shorter course of hormone treatment, it turns out, may deliver substantial benefits. In the Aug. 18 *Journal of the American Medical Assn.*, researchers at Brigham & Women's Hospital and Dana-Farber Cancer Institute show that only six months of such therapy boosts by 10% the likelihood of surviving five years. Senior author Dr. Philip Antoff says this means more patients can benefit from hormone therapy while minimizing the side effects.



DRINKING WATER ARSENIC AND NEW ANTIDOTE

ARSENIC IS AN insidious poison. It appears naturally in groundwater worldwide and can do harm long before any signs are evident. Its worst effects are apparent in Bangladesh, where 30 million



people are at risk because of tainted wells. Exposure can destroy the skin (left), harm internal organs, and cause cancer.

K.J. Reddy, an associate professor and water quality expert at the Univ. of Wyoming, has synthesized a compound that neutralizes water-

borne arsenic. Other methods exist, but most are expensive and require pretreatment of the water. Reddy says his secret formula could be used in a sachet—like a tea bag—to clean a pitcher of water and could be made affordably in developing countries.

The U.S. could use help as well. The Environmental Protection Agency has ruled that threshold levels for arsenic in drinking water must be cut by 80%, to 10 micrograms per liter, by 2006. Meeting that limit could be especially costly in western states, where levels are high (map). Reddy has licensed his recipe to HydroFlo in Raleigh, N.C.

TERROR WATCH CRACKING THE CODE OF A SUSPECT PC

INFORMATION FOUND on PCs used by terrorists has already unmasked several "sleepers" in the U.S. and Europe. But sifting through the haystack of data on a hard drive can be arduous, especially if info is encrypted. Typically, this task falls to digital forensics labs, which can take days or weeks to probe a PC. Cracking this data vault faster, before the bad guys have time to react,

could make a big difference.

Next year, the Pentagon hopes to give Special Forces units and some front-line soldiers a tool to do just that. The software, being developed by IDEAL Technology in Orlando, combines foreign-language software tools, artificial intelligence, and sophisticated search and data-mining algorithms—all running on a sub-\$10,000 laptop. A suspect PC or PDA can be linked to the system and "out the other end comes targeted information," says co-founder Jordan S. Jacobs. "The process can be entirely automated." —Otis Port

CALLING ALL CARS THIS GIZMO'S RAYS COULD HALT EVEN O.J.'S BRONCO

TV HELICOPTER CREWS, your glory days may be numbered. Police in the car-chase capital of the world are getting set to stop fugitives in their tracks.

The Los Angeles Sheriff's Dept. has ordered a high-energy radio wave device developed by Eureka Aerospace in El Segundo, Calif. Troopers will be able to use it to scramble the digital brains—computer chips that control fuel injection, engine firing, and other functions—in most cars. With its engine shut down, the targeted car would roll to a stop.

The ray, which proved effective at a range of 160 feet in testing in early July, projects from an antenna that can be mounted on the roof of police cruisers. The company is developing beams that could either permanently fry the car's electronics or simply temporarily disrupt them.

L.A. has averaged over two car chases a day in recent years, causing interminable traffic snarls and nearly 300 collisions. The zapper will probably go into production for Tinseltown cops after a prototype is finished at the end of this year, says James Tatoian, Eureka's chairman and CEO. —Jasper Perkins





FIX-IT MAN His IDS division is back in the black

Boeing's Favorite Supergeek

Defense success has made James Albaugh a strong contender for the top spot

BOEING CO.'S DEFENSE Chief James F. Albaugh has never cared much for the trappings of power. In 2002, shortly after he took over Boeing's military aircraft and missile unit in St. Louis, he closed the office's executive dining room. Albaugh wanted to create an open culture, where engineers could

voice their ideas to senior executives anytime, anywhere—even if it meant interrupting a bigwig's lunch. That's how it was in Albaugh's early years as a hard-driving engineer at Rockwell Aerospace, which was acquired by Boeing in 1996. And that's how it had to be, he believed, to make Boeing a formidable contender in the defense business. "I don't want to create barriers," says Albaugh, 54.

The unpretentious Albaugh has been a steadying anchor for a company that is still reeling from a string of scandals. Albaugh's former boss, ousted Chief Financial Officer Michael Sears, is expected to enter a plea shortly as part of a U.S. government investigation into allegations that he improperly offered a job to a former Air Force procurement official while she was deciding whether to buy Boeing 767 tankers. The official, Darleen Druyun, pleaded guilty to one count of criminal conspiracy in April. She is expected to be sentenced in September. Meanwhile, the U.S. Air Force penalized Boeing for possessing stolen documents from Lockheed Martin Corp. by pulling out of \$1 billion worth of contracts, giving them to Lockheed. The scandal forced Boeing Chief Executive Officer Philip M. Condit to resign in December.

THEIR APPARENT?

AMID THE TURMOIL, Albaugh has quietly emerged as one of a handful of candidates to take the top spot at Boeing when its current CEO, Harry C. Stonecipher, retires in 2006. It's easy to understand why. Albaugh's division, Integrated Defense Systems (IDS), is the only Boeing unit that is living up to the promise Condit laid out when he acquired McDonnell Douglas Corp. in 1997: to boost profits by pursuing services, aerospace, and defense. In 2003, Albaugh was charged with integrating Boeing's military aircraft and space units, which had been cobbled together from Rockwell and McDonnell Douglas divisions, as well as from a 2000 acquisition of Hughes's space division. While Boeing lost its lead in commercial jets to Airbus, Albaugh has made up for the shortfall by leveraging Boeing's diverse technological expertise to push it beyond shrinking markets such as building fighter jets.

It's working. In June of this year, the U.S. Navy picked IDS to build antisubmarine warfare jets—a contract potentially worth \$44 billion. And in August, the U.S. Air Force accelerated a project called Future Combat Systems, for which IDS will develop advanced communications network. The job now worth \$21 billion. IDS, whose major operations are in St. Louis and Southern California, booked \$51 billion in new business in 2003, up from \$38 billion in 2002. In the first half of 2004, the unit's revenues jumped 14% over the same period in 2003, to \$14.6 billion. It swung from a \$398 million operating loss to a \$1.4 billion profit.

Albaugh has many more hurdles to cross, though, before his path to the top of the suite is secured. He has not been im-

in any of the tanker miscon-
 ct. But as the Pentagon con-
 siders other options to replace
 its aging fleet, Albaugh will
 have to persuade Secretary of
 Defense Donald H. Rumsfeld
 and lawmakers in Congress
 that the 767 tanker is still the
 best choice. Furthermore, he
 has to figure out how to turn
 around IDS's commercial satel-
 lite arm. The business has been
 plagued by cost overruns and a

slumping market, prompting a \$1.1 billion
 writedown last year. As for the new military
 contracts, Albaugh will have to deliver net-
 working technology that Boeing has never
 been called on to develop before. "It's one
 thing to market and another to execute,"
 says Loren B. Thompson, COO of the Lex-
 ington Institute, a defense think tank.

Execution will determine whether Al-
 baugh rises above other strong CEO can-
 didates, including Alan R. Mulally, who
 now heads Boeing's commercial air-
 lines unit. While Mulally is more out-
 wardly aggressive, Albaugh has more ex-
 perience on the defense side, which now
 counts for over half of Boeing's sales.

In the face of so much pressure, Al-
 baugh remains unflappable. An engineer
 with a history buff with a penchant for col-
 lecting Italian wine, Albaugh prefers to fly
 under the radar. Beneath the 6-foot, 5-
 inch former basketball player's imposing
 frame is a supergeek who savors the sci-
 tific challenge of building rockets and
 assembling complex communications
 systems. "Jim really is a rocket scientist,"
 says Boeing CEO Stonecipher.

Albaugh has called on that expertise in
 his role as chief architect of Boeing's plan
 to become the world's leading provider of
 next-generation defense technologies.
 One of his biggest wins was the contract
 with the Army, which tapped Boeing to
 create an information network that will
 connect tanks, planes, and armored troop
 carriers with soldiers on the battlefield. To
 make up the deal, Albaugh mixed talent
 from disparate divisions that had not
 been inclined to work together before. He
 hatched up Boeing's experts in data min-
 ing with Hughes engineers, who know
 how to integrate data with communica-
 tions systems. Then he threw in profes-
 sionals who had worked on the Apache
 helicopter, because they understand how
 the Army thinks about battle manage-
 ment. Such integration will be crucial to
 winning in more defense contracts. "Al-
 baugh is way ahead of the curve in terms
 of understanding how to shape and grow
 these new markets," says Richard L.

A big challenge: Fixing Boeing's satellite business

Aboulafia, vice-president of
 analysis for consultants Teal
 Group Corp.

Albaugh has been training
 for this challenge his entire life.
 As a boy in Richland, Wash.—
 home of the Hanford nuclear
 site—he was surrounded by
 scientists, including his father,
 who worked as a chemist at the
 facility. Albaugh took an early
 liking to science and dreamed
 of building dams. But by the

time he completed his engineering edu-
 cation in 1974, most of the country's dams
 were already finished. So he took a job as
 an engineer with Rockwell Aerospace.
 "Rocket science has a lot in common with
 building dams," he explains. "But instead
 of dealing with fluid flows, you have gas
 flowing through rocket engines."

TURNAROUND TALENT

ALTHOUGH ALBAUGH was a talented en-
 gineer, he also built a reputation as a
 shrewd turnaround specialist. He made his
 biggest mark in the early 1990s, when he
 was appointed fix-it man for Rocketdyne, a
 division that built rocket engines. Rocket-
 dyne's factory was over budget, so Albaugh
 reorganized the assembly line and trained
 workers to improve their efficiency. Col-
 leagues remember him as a somewhat ob-
 sessive manager. Rick Bailey, the former

head of the Rocketdyne factory and now a
 vice-president for IDS, recalls that Al-
 baugh once left him a Post-It note with a
 cigarette butt stuck to it—a reminder that
 efficiency includes sweeping the floor.

Maybe those neat-freak tendencies will
 help as Albaugh attempts to clean up
 Boeing's commercial satellite business.
 Two years after Boeing bought Rockwell
 Aerospace in 1996, Albaugh was named
 head of the space and communications
 unit. He championed the plan to acquire
 Hughes's space division, hoping it would
 boost Boeing's expertise in satellite com-
 munications and network defense sys-
 tems. Now he's racing to update Hughes's
 antiquated manufacturing procedures
 and improve design flaws that caused
 some satellites to fail. "Hughes left us
 with a bunch of bad programs," Albaugh
 says. "I'm accountable."

The woes in the satellite business once
 led Boeing's board to consider dumping
 Albaugh. They even tried to make a list of
 possible replacements. Then the military
 contracts started flooding in, and all they
 came up with was a blank sheet of paper.
 "We concluded that this guy is really
 good," Stonecipher says. As he works
 through each new challenge, Albaugh is
 getting closer to turning Boeing into a de-
 fense powerhouse—and to securing his
 own meteoric rise to the top. ■

—By Stanley Holmes in Seal Beach, Calif.

BIO

James Albaugh

Albaugh is leading Boeing's push into
 next-generation defense technologies.

BORN May 31, 1950,
 Richland, Wash.

EDUCATION B.S., mathematics
 and physics, Willamette
 University, 1972; M.S., civil
 engineering, Columbia
 University, 1974.

CURRENT POSITION CEO of
 Boeing's Integrated Defense
 Systems, the nation's No. 2
 defense contractor behind
 Lockheed Martin.

DEFENSE ROOTS His dad was a
 chemist in Richland, where
 America's first atomic bomb was
 built at the Hanford nuclear site.
 Starred as a "shooting" forward
 on the Richland High School
 basketball team, called the
 Bombers.



HOBBIES Studying history,
 gardening, golf (nine handicap),
 and collecting wine, especially
 from the Piedmont in northern
 Italy.

PERSONAL Married to Audrey
 since 1982.

BIG WIN In June the Navy
 picked his division to build
 an antisubmarine version
 of the 737 (above). The contract
 is worth up to \$44 billion.



Does It Pay to Buy Organic?

For pregnant women and children, the benefits are worth the higher price. **BY CAROL MARIE CROPPER**



KIM DENNIS—with her 2-, 4-, and 6-year-olds in tow—looked over the fruit at a Whole Foods Market in Atlanta. She picked up a pint of organic blueberries selling for \$5.99. Nearby, conventionally grown ones went for \$4.99. She put the organic berries in her basket. “I think it’s definitely worth paying more,” she says. “If they sit there and eat a whole pint of berries, that’s a lot of pesticides for their little bodies.” With shoppers like Dennis willing to plunk down 10%, 20%, sometimes even 100% more, organic food sales hit \$10 billion in 2003, up from \$178 million in 1980. Responding to the growing demand, mainstream grocers are stocking more organic produce, milk, baby food, and meats, while healthy-

food chains such as Whole Foods have opened dozens of stores in the past five years. Food certified under U.S. Dept. of Agriculture regulations as organic must be produced without most synthetic pesticides and fertilizers. Antibiotics, growth hormones, and feed made from animal parts are also banned.

Is organic worth the extra money? Research has yet to prove an adverse health effect from consuming the low levels of pesticides commonly found in U.S. food.

But for the most vulnerable groups—children and pregnant women—going organic whenever possible for fruits and vegetables that carry the heaviest pesticide load makes sense. For organic meat, poultry, eggs, and milk, the direct health benefit is less clear. It might come down to your willingness to pay more to avoid supporting certain agricultural practices, such as antibiotic use in animals, which could promote resistant bacterial strains, or the use of growth hormones, which

could prematurely wear down the arteries.

Even organic advocates say conventional fruits and vegetables are probably worth the premium. For example, at Atlanta Whole Foods, organic bananas cost 78¢ a pound, 30¢ more than regular bananas. But there’s almost no health benefit to buying organic in this case, according to Charles Benbrook, technical director of the nonprofit Organic Center for Education & Promotion, founded with the support of the industry’s Organic Trade Assn. Any pesticide residues probably discarded along with the peels.

REPEAT OFFENDERS

OTHER PRODUCE CONTAINS sometimes the amount of pesticides as the organic equivalents, and the residues can be peeled or washed away. Some 9% of the peaches tested by the USDA in 2002 showed evidence of at least one pesticide (www.ams.usda.gov/science/pdp). Repeat offenders over the years include



BIG BUCKS

Organic food sales hit \$10 billion in 2003

through age 12, and with young livers and immune systems less able to rid bodies of contaminants, eating organic is more important for children and pregnant or breast-feeding women.

But even then, the argument for some foods is less compelling. While 47% of the produce sampled by the USDA in 2002 had detectable pesticide residues, only 16% of grains and 15% of meat tested did. Most of the residues found in meat (almost always in the fat) were from long-banned chemicals like DDT, which remain in the environment and is not a problem organic farming methods can solve.

Widespread use of antibiotics and growth hormones is a larger issue for those considering organic meat, poultry, eggs, and milk. Here, the major health benefit to consumers is indirect. Antibiotic use in animals helps promote antibiotic-resistant strains of bacteria, explains Urvashi Rangan, director of eco-labels.org, a site developed by Consumers Union, publisher of *Consumer Reports*. And while the U.S. Food & Drug Administration says the growth hormone used in cattle is virtually identical to what cows naturally produce, consumer groups such as Consumers Union argue that milk from treated cows has higher levels of a growth factor linked to increased cancer risk.

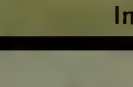
With meat, a more recent concern is

ples, strawberries, and pears—fruits children gobble as finger food (table). That's worrisome given that contaminants pose the biggest risk to children and fetuses. Pesticides have been shown cross the placenta during pregnancy, and a recent study by scientists at the Columbia Center for Children's Environmental Health in New York found a link between pesticide use in New York apartments and impaired fetal growth. Another study, from the University of Washington in Seattle, found that preschoolers fed conventional diets had six times the level of certain pesticides in their urine as those who ate organic foods. And a 2003 report from the Centers for Disease Control & Prevention detected twice the level of some pesticides in the urine of children in that of adults. Few doubt that high doses of pesticides can cause neurological or reproductive damage. With infant reproductive organs still forming and the brain developing

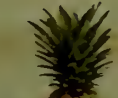
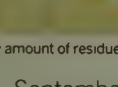
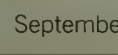
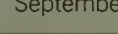
Picking Your Produce

Some fruits and vegetables are more likely to have pesticide residues than others. When buying organic foods, it's best to focus on the produce where it makes the most difference.

Most Contaminated*

-  Peaches
-  Strawberries
-  Apples
-  Spinach
-  Nectarines
-  Celery
-  Pears
-  Cherries
-  Potatoes
-  Sweet Bell Peppers
-  Raspberries
-  Imported Grapes

Least Contaminated*

-  Sweet Corn
-  Avocados
-  Pineapples
-  Cauliflower
-  Mangos
-  Sweet Peas
-  Asparagus
-  Onions
-  Broccoli
-  Bananas
-  Kiwi
- Papaya

*Ranked by amount of residue. Data: Environmental Working Group (foodnews.org)

(PINEAPPLE) EISENHUT & MAYER/FOODPIX; (PEACHES) EISENHUT & MAYER/FOODPIX; (PEA PODS) EVAN SKLAR/FOODPIX; (BANANA) BRIAN LEATART/FOODPIX;

bovine spongiform encephalopathy, or mad cow disease. The disease spreads when cows ingest animal feed made with parts from dead animals. The human form of the illness, Creutzfeldt-Jacob Disease, is believed to be caused by eating contaminated beef. It is always fatal. The risk of contracting the disease, however, is low. The U.S. has had only one confirmed case of mad cow disease, and the only

American case of CJD involved a woman who contracted it in Great Britain.

Whether to shell out more for organic beef will depend on your budget—and how seriously you take the threat of mad cow disease. Other ways to lower the odds include avoiding processed meats such as hot dogs and preground hamburger that might contain bits of brain or spinal cord and eschewing cuts sold with the bone,

says Michael Hansen, a senior research associate at Consumers Union.

The next product in line for organic certification is fish. The USDA is studying what such certification would involve.

Remember that despite all the things you could worry about, America's food supply is among the safest in the world. And organic or not, it's still important for your children to eat their vegetables.

Q&A

Why Off-Menu Is In Vogue

Danny Meyer spills the beans.

WHEN DANNY MEYER was an assistant manager at the now-defunct Italian restaurant Pesca in 1984, he received one of his first special dietary requests from Arthur Ashe. The tennis star, who had undergone double bypass surgery, provided a lengthy description of his needs—no butter, no frying, no marinades. Figuring Ashe would demand a heart-healthy dessert as well, Meyer had the kitchen prepare a fruit plate. But when Ashe finished his main course, he wanted pecan pie—à la mode.

Meyer, now president of the Union Square Hospitality Group, which includes New York's Union Square Cafe and Gramercy Tavern, spoke with Personal Business Editor Lauren Young about how gourmet restaurants cope with customers' culinary eccentricities.

What do you think about people's attitudes toward food?

I have met an enormous number of people similar to Arthur Ashe who follow the denial-and-reward cycle of dining. The thinking is: As long as I eat my spinach, I can eat that chocolate cake.

How have low-carb diets affected business?

We have more examples of people ordering a sandwich or burger, and saying: "Can you hold the bun?" But our restaurants put bread on the table, and we are not buying less bread than we used to.

What's the oddest off-menu request you've ever received?

When William Shawn, the late editor of *The New Yorker*, used to come in to Union Square Cafe, invariably he'd ask for a bowl of cereal and dry toast. It would be 1:30 p.m., and we'd be in the midst of lunch hour rush. Someone would run across the street to the store to get him cereal. We started keeping a couple of cereal brands in the kitchen just for him, but he always seemed to want a different brand than what we had stockpiled. Shawn was always the guest of Roger Straus, founder of [publisher] Farrar, Straus, and Giroux. He came in three to five times per week. I thought it would be offensive to charge for a bowl of cereal. It was the least we could do as an amenity for a loyal customer.

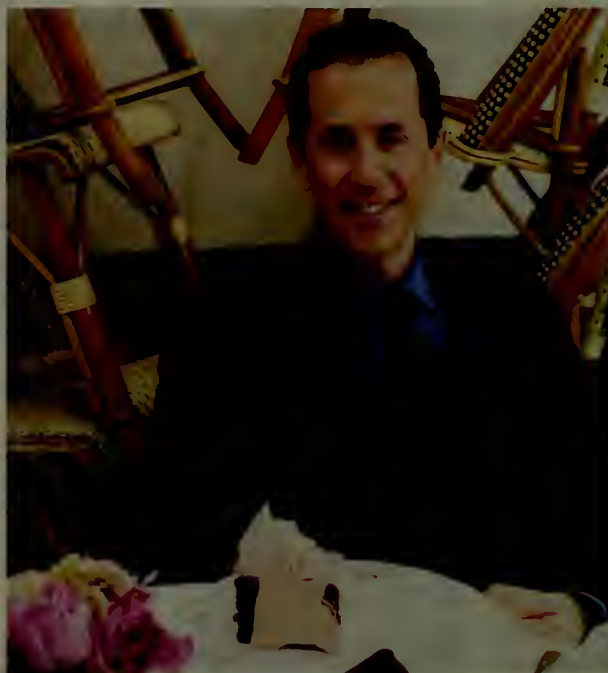
Aren't chefs offended by that kind of request?

Not the kind I'd hire. I'd be furious if anybody told a customer we couldn't meet

their request. André Soltner from Lutèce tells a story of a chef who was offended when someone ordered steak frites with the steak well done. Soltner told the chef: "If somebody wants a well-done steak, your job is to make the best well-done steak they've ever had."

Where do you stand on the popular diets?

We're not anti-carb, and we're not pro-protein. We're in favor of balance. At Union Square Cafe, we've always taken our cue from the Mediterranean diet. Pastas served as a small appetizer. We give our customers sensible portions of vegetable, protein, fruit, and bread.



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Zippering Through Airport Security

The Registered Traveler Program can get you to the front of the line. **BY KATE MURPHY**

A FREELANCE SPORTS videographer who supplies footage to ESPN and Fox Sports, Brad Mitten of Houston travels several times a week. Whether he's jetting off to cover a PGA tournament or NFL game, he usually has to endure long lines at the airport to get through security. "It's a real hassle," says Mitten. So before he left to cover the Olympics this month, he enrolled in the Registered Traveler Program recently introduced by the U.S. Transportation Security Administration (TSA). By giving up a measure of privacy, Mitten hopes he'll avoid some of the delays associated with post-September 11 travel.

The TSA rolled out the program in July at select airports across the country. It's up and running at Minneapolis-St. Paul

International, Los Angeles International, and Houston George Bush Intercontinental. Boston Logan International and Ronald Reagan Washington National will offer it by the end of August.

READING IRISES

REGISTERED TRAVELERS GET to bypass the usual security checkpoint and stand in their own designated quick queue. There, a biometric device that looks like an automated teller machine takes about five seconds to clear them by reading either their fingerprints or irises. Registered travelers still have to go through a metal detector and have their carry-on baggage pass through an X-ray scanner. But these individuals won't be randomly selected for additional screening. "The main benefit is you essentially get to go to the front of the line," says Jim Marc-

hand, a federal security director with

To qualify for the program, you must be a U.S. citizen or permanent legal resident who flies out of a participating airport at least once a week. You also must be a frequent flier with the carrier that's working with the TSA at that airport. The official carriers are Northwest Airlines in Minneapolis-St. Paul, United Airlines in Los Angeles, Continental Airlines in Houston, and American Airlines in Boston and Washington.

You can register at sign-up stations at the airports. If you meet the basic criteria, you're invited to fill out an enrollment form, which asks for your name, birth date, Social Security number, contact information, and addresses of all the places you have lived in the past five years. You must also submit two kinds of government identification, such as your passport and driver's license. After that, a TSA representative will take digital scans of your irises and your index fingers. "It takes 10 minutes at the most," says Marchetti. There are no fees because the program is still in its testing phase.

PRIVACY WORRIES

THEN YOU WAIT seven to 10 days to see if you pass the background check. Although the TSA is not specific, it says the security investigation includes checking several crime databases for outstanding warrants, prior arrests, and convictions. Kevin Mitchell, chairman of the Business Travelers Coalition, a Radnor (Pa.) advocacy group, says he has concerns about the privacy of registered travelers. "No one knows what rules are in place to guard personal information," he says. Recent revelations that JetBlue Airways and Northwest Airlines inappropriately shared passenger information with the TSA and the airlines' contractors made travelers "justifiably worried" their data might be misused," he adds.

In its privacy statement, TSA says it will not share personal information with anyone unless it is necessary to assist in the operation of the program, including equipment supplied by airport officials, airlines, law enforcement officials, and other government agencies. Despite this level of exposure, TSA officials report intense public interest. More than 7,200 people have applied to participate so far.

The test phase will conclude at the end of October. The TSA will then determine whether to expand the program to other airports and how much to charge applicants. For travelers, it boils down to what they value more—convenience or confidentiality. ■

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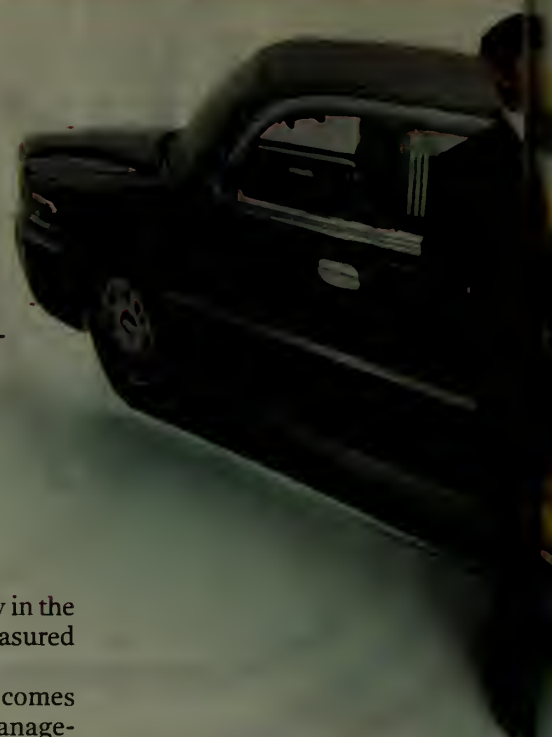
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How to Spot a Closet Index Fund

It may charge a hefty management fee, but its portfolio is pretty generic. **BY LEWIS BRAHAM**



POP OPEN THE HOOD OF the Putnam Voyager Fund, and the contents may look familiar. That's because its top five holdings—Pfizer, Microsoft, Intel, Cisco Systems, and Johnson & Johnson—are also the same top five that are in its benchmark, the Russell 1000 Growth Index. If you look at Voyager's recent returns, they're very similar to the Russell index as well. The only major difference: Voyager's performance lags after subtracting its management fees.

Voyager is, as the fund experts say, a "closet index fund." It charges relatively high fees for what is essentially a generic portfolio. This isn't much of an issue for many investors in a bull market, when returns are high. But when the market is stagnant or sagging, as it is now, it can hit your bottom line badly. Voyager's 1% annual expense ratio is below average for equity funds, but in an environment in which stocks are expected, at best, to deliver only 8% or 9% a year, the fee consumes more than 10% of your total return. A comparable index fund, iShares Russell 1000 Growth, offers similar results for one-fifth the cost.

Asset size explains in part why funds become index huggers. "As funds grow, managers have to increase their number of holdings so they don't have too much money in any one stock," says Jeremy DeGroot, director of fund research at Litman/Gregory Asset Management in Orinda, Calif. "Otherwise, they have trouble trading in and out of their positions." DeGroot thinks most funds need no more than 50 stocks to be well diversified, after which they begin behaving increasingly like an index fund. "Managers start to own stocks in which they don't have any conviction," he says. Those managers

often turn to stocks that are already in the index because they are being measured against that benchmark.

This closet indexing problem comes from the way the investment management industry works. Investors, both large and small, don't usually pull their money out of mediocre mutual funds—only the really poor performers. So once a fund company has a pile of assets, it may become risk averse, preferring to hew to the index rather than make large bets that can either pay off large for investors or cause them to take their money and run. "They're trying to stay close enough to the benchmark so they don't get fired," says Jeff Molitor, director of portfolio review at fund giant Vanguard Funds.

BENCHMARK-AWARE

THE \$9.5 BILLION Voyager Fund holds 179 stocks, and each one adds something unique to the portfolio, says Steve Oristaglio, Putnam's head of investments. "Your 85th stock pick plays an

important role," he says. "It may have the expected return of your stock, but in combination with other stocks in a portfolio it produces the risk-adjusted returns." Even if the five stocks are the same as its benchmark, Oristaglio says the rest of the portfolio is different enough from the index and that stocks such as Adobe Systems, Citigroup, Costco Wholesale, and Bank of America are overweight relative to the benchmark. In addition, Oristaglio says the fund's average market capitalization and trailing price-to-earnings ratio differ from the Russell 1000 Growth Index. But he acknowledges Putnam managers are "benchmark-aware" and that if they deviate

Big Index Huggers

FUND/SYMBOL	3-YR. AVG. ANNUAL RETURN*	INDEX**	ASSETS (BILLION)
Fidelity Magellan (FMAGX)	-3.7%	S&P 500	\$65
Putnam Fund for Growth & Income A (PGRWX)	-0.6	Russell 1000 Value	11
Putnam Voyager A (PVOYX)	-6.8	Russell 1000 Growth	9
AXP New Dimensions A (INNNDX)	-3.7	Russell 1000	9
Fidelity Mid-Cap Stock (FMCSX)	-4.4	Russell Midcap Growth	8
Franklin Small-Mid Cap Growth A (FRSGX)	-2.4	Russell Midcap Growth	7
MFS Mass. Inv. Growth Stock A (MIGFX)	-6.7	Russell 1000 Growth	7
Oppenheimer Capital Appreciation A (OPTFX)	-4.3	Russell 1000	7
Putnam New Opportunities A (PNOPX)	-6.8	Russell Midcap Growth	7
T. Rowe Price Intl. Stock (PRITX)	-0.1	MSCI EAFE	7

Data: Morningstar. *Appreciation plus reinvestment of dividends and capital gains before taxes through July 31, 2004. **Index with which the fund is highly correlated. All portfolios hold more than 100 stocks and have an R-squared of 95 or higher, meaning the returns are closely correlated with the index.



significantly in sector or stock weightings from their benchmark, they need to have a strong reason for doing so.

Of course, not every big fund with a lot of stocks is a closet indexer. One of the best ways to identify an index hugger is by using a statistic called R-squared (or R^2), which measures the percentage of a fund's movements that can be explained by fluctuations in a benchmark index. The Vanguard 500 Index Fund has an R^2 of 100, according to fund tracker Morningstar. You can get those statistics at morningstar.com.) That means the Standard & Poor's 500-stock index determines 100% of its price movements—up or down. “Any fund with an R^2 of 95 or above raises eyebrows as a potential index hugger,” says

Jeff Ptak, senior analyst at Morningstar (table). By this standard, Voyager's R^2 of 97 in relation to the Russell 1000 Growth Index is a dead giveaway. Oristaglio says that's not proof that Voyager is a closet indexer. In fact, he argues that the R^2 statistic has gone up for funds in general because investors are making fewer distinctions between stocks.

R^2 can reveal important differences even in funds within the same family. Consider the \$39 billion Fidelity Contrafund and the \$66 billion Fidelity Magellan fund. Contrafund has 608 stocks in its portfolio but only an 83 R^2 with the S&P

MidCap 400, the benchmark it most closely tracks. By contrast, Magellan has 222 stocks and a 99 R^2 with the S&P 500. Contrafund is also the better performer, having a 4.7% three-year annualized return vs. Magellan's -3.7%.

SHADOW INDEXING?

WHY ARE THE two funds so different? “When people think of Magellan, they think of Fidelity, and Fidelity is very sensitive to any bad news at the fund,” says Jim Lowell, editor of the *Fidelity Investor* newsletter. In the mid 1990s, for instance, then Magellan manager Jeffrey Vinik, expecting the market to fall, put 20% of the fund into bonds. When the market rallied, the fund lagged—and Vinik and Fidelity were widely criticized. So rather than risk an aggressive bet, Magellan now shadows the S&P 500, Lowell says. By contrast, investors in Contrafund expect it to zig when the market zags. After all, its name is derived from contrarian. Fidelity spokesman Vincent Loporchio denies that Magellan is intentionally tracking the index. “The fund generally holds a relatively large number of stocks that are not part of the S&P 500,” he says. Maybe so, but it still behaves like the index.

Fees at Magellan are reasonable for an actively managed fund, 0.7%, so it may make sense to hold on if you already own it. But when funds charge through the nose for index-like performance, it's particularly offensive. For instance, Merrill Lynch International B has a 96 R^2 and a 2.8% expense ratio, making it nigh impossible to beat its benchmark, the MSCI EAFE Index, over the long term. A Merrill spokesperson denies that it's a closet indexer, citing different country and sector weightings.

If you're holding an expensive index hugger, the best advice is to sell it. Then what? You can buy a comparable index fund and save money. Or, if you can tolerate greater volatility, you can pay for a genuine actively managed fund by choosing one with a portfolio of fewer than 50 stocks. Jensen Fund, Marsico Focus, PBHG Clipper Focus, and Legg Mason Value Trust are good examples.

The third, and possibly the best, alternative is to combine the two strategies. Place, say, 90% of your money in index funds and the remaining 10% in more focused funds. You'll get as much active management as closet index funds provide, at a much lower cost. ■

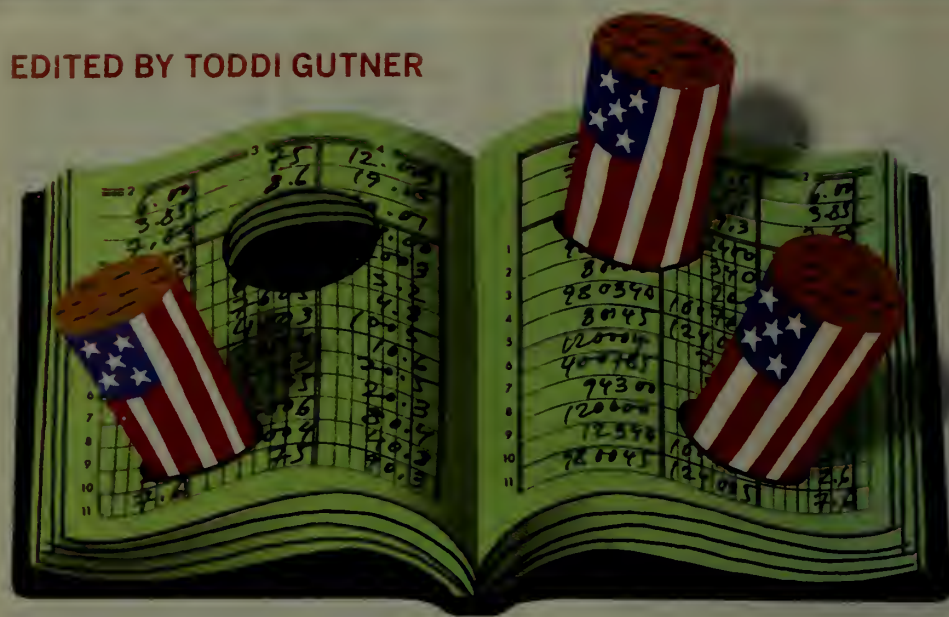
If you're holding a pricey index hugger, the best move is to sell it

Expensive Index Huggers

FUND/SYMBOL	3-YR. AVG. ANNUAL RETURN*	INDEX**	EXPENSE RATIO
Merrill International B (MBILX)	-0.7%	MSCI EAFE	2.82%
Principal Small Cap B (PLLBX)	-1.9	Wilshire 4500	2.70
AIM Dent Demo Trend B (ADDBX)	-7.6	Russell Midcap Growth	2.66
Thrivent Partner Intl. A (AAITX)	-1.0	MSCI EAFE	2.46
Hancock Small Cap Growth B (TSEGX)	-5.2	Russell 2000 Growth	2.40
Strategic Partners New Era Growth B (SNGBX)	-5.7	Russell 2000 Growth	2.41
Morgan Stanley Intl. B (INLBX)	1.1	MSCI EAFE	2.37
Alliance Bernstein Small Cap Growth (QUASX)	-2.8	Russell 2000 Growth	2.32
ING Emerging Countries A (NECAX)	8.4	MSCI EAFE	2.27
Strategic Partners Capital Income M (IBEIX)	-3.8	S&P 500	2.17

Data: Morningstar *Appreciation plus reinvestment of dividends and capital gains before taxes through July 31, 2004 **Index with which the fund is most highly correlated. All portfolios hold more than 100 stocks, and have an R-squared of 95 or higher, meaning the returns are closely correlated with the indexes

EDITED BY TODDI GUTNER



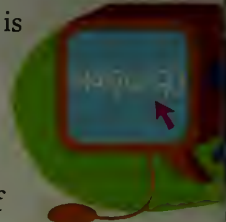
EDUCATION

CAMPUS CONFIDENTIAL ON THE WEB

YOU AND YOUR COLLEGE-BOUND kids can get the inside scoop on campus culture at more than 800 universities from the people who really know—the student body. **CampusDirt.com**, the four-month-old offspring of scholarship search engine **FinancialAid.com**, surveyed more than 70,000 college students and recent graduates to find the truly quiet study spots, primo late-night takeout haunts, and whether the professors really know their stuff.

Pinocchio's Pizza is a favorite at Harvard, for example, and Lehigh is known as a party school. At Tulane, 25% of the respondents

said the student body is very ethnically and culturally diverse; 28% felt it was not very diverse. "If you're good at dealing with upper middle class/upper class status, don't come here," advises Paige of the Class of 2006. How's the faculty at Stanford? "We have some world-class scholars, Nobel prize winners, and leaders in their field who teach freshman courses because they love students," one student says. "It's pretty awesome." —Diana Middleton



BONDS

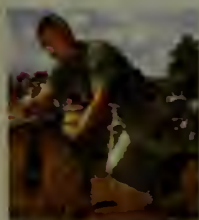
Sunset for CoCos?

CONTINGENTLY CONVERTIBLE BONDS, known as CoCos, account for 84% of the convertible securities issued this year. But new issuance could fall and even disappear next year if the **Financial Standards Accounting Board (FASB)** has its way. Like all convertible bonds, CoCos can be swapped for equity if the share price reaches a certain target. But the trigger price at which a CoCo can be exchanged for stock is typically 20% to 30% higher than the threshold for a regular convertible. Corporations love CoCos because unlike with regular convertibles, the shares they're exchangeable for don't have to be counted in earnings per share until the stock reaches its trigger price. But when CoCos hit the target, shareholders can get a nasty surprise, since that's when the number of shares outstanding rises and EPS falls.

Now, FASB wants to make issuers count CoCos in EPS calculations as soon as the bonds are issued, and restate past results. Unless lobbyists head off the change, Bear Stearns projects that among issuers, EPS will fall by 6% in 2005. With the loophole closed, fewer companies are likely to choose this financing method. —Anne Tergesen

TIME OFF

WHERE BOURBON REMAINS KING



BARDSTOWN, KY., the self-proclaimed bourbon capital of the world, hosts its annual **Kentucky Bourbon Festival** on Sept. 15-19 (kybourbonfestival.com). Among the highlights:

An auction of master-distiller bourbons, a chili cook-off, and a barrel rolling contest. Bardstown is about 40 miles southwest of Louisville in Bluegrass Country, where the corn-based whiskey was first distilled in charred oak barrels some 200 years ago.

BROKERS

Most full-service brokerage firms offer unlimited protection to clients, over and above the \$500,000 per account covered by Securities Investor Protection Corp. But many **major discount brokers fall short of a promise** to make sure clients get the full value of their accounts. Should a disaster strike one of them that causes the company to go belly-up, investors are likely to get only a few cents on the dollar, according to a survey by Stern & Co., a New York investor-relations firm. There is at least one discount broker that does offer full coverage: Muriel Siebert & Co.

DISCOUNT FIRM	COVERAGE (MILLIONS)	TOTAL CUSTOMER HOLDING (BILLION)
Ameritrade	\$100	\$63
Charles Schwab	600	992
E*Trade	200	76
Quick & Reilly	600	NA
TD Waterhouse	150	125

NA: Not Available

Data: Stern &



BY ROBERT BARKER

This Car Dealer May Be Going Places

Given the death and destruction trailing Hurricane Charley, anyone might miss noticing some of its minor victims. One would be CarMax, the chain of used-car superstores with many outlets in Florida and throughout the soggy Southeast. As skies there cleared, a low-pressure system hovered over CarMax shares.

The damper Charley put on car shopping is not the first trouble CarMax has suffered. Since January the stock is off by nearly half, to \$19, as the Glen Allen (Va.) company keeps warning that business is softer than expected. On Aug. 17, Wall Street analysts got a fresh reason to cut ratings on CarMax when it said same-store sales of used cars in its fiscal second quarter, ending Aug. 31, would fall. While that was a foregone conclusion. Just the same, I bet investors now have a chance to get a good growth stock at a reasonable price.

THE OTHER DAY, I STOPPED at CarMax in Orlando, one of its 55 locations. Within 50 minutes, I had examined several convertibles, including Ford Mustangs, a Mitsubishi Eclipse Spyder GT, and a BMW Z3. I also test-drove a sweet 2000 Mazda MX-5 Miata with just 35,000 miles on it. While I loomed around in the Miata, CarMax appraised my current car and made a solid offer on it. CarMax would buy my car whether I bought a new one that day or, as it happened, did not. That's the key to CarMax: It sets no-haggle prices on cars for sale. It makes a no-haggle offer on the car you bring in, and you're free to take any part or all of the deal and finance it as you like without the customary buyer-dealer warfare. Sales reps get paid the same whether you buy a Kia or a Corvette. As one told me: "There are no mind games."

Appealing as that is to car buyers, it should be no surprise that since 1993, when CarMax opened its first location in Richmond, Va., it has spread to 25 more markets. The financial results are compelling. Since fiscal 2000, sales have more than doubled, to \$4.6 billion, in fiscal 2004, ended Feb. 9. Net earnings for the fiscal year grew 23%, to \$116.5 million. This year, as CarMax aims to add 10 stores, revenue may grow an additional 13%, to \$5.2 billion or so, even if wary consumers slow car purchases. Despite that prospect, CarMax figures to remain solidly profitable. With a healthy balance sheet and a focus on the less competitive market in used cars, CarMax enjoys wider margins than other publicly



Car Wars

COMPANY/SYMBOL	STOCK PRICE*	ENTERPRISE VALUE**	REVENUE	OP. INCOME	EV/OP. INCOME	PRETAX MARGIN
AutoNation (AN)	\$16.05	\$8,323	\$19,720	\$713.2	11.7	2.9%
CarMax (KMX)	19.07	2,084	4,750	187.9	11.7	4.0

Dollars in millions. Income statement data for latest 12 months. *Aug. 23 **Stock market value plus net debt. Data: Company reports, BusinessWeek

held auto dealers, notably leader AutoNation. Yet investors value the two stocks at equivalent multiples (table).

Still unknown in vast parts of the U.S., CarMax plans to expand its base of stores by 15% to 20% a year, which suggests 11 or so more next year and eventually over 250. The company figures that in areas it has served the longest, its market share for cars that are one to six years old runs 8% to 10%. At similar rates nationally, CarMax would see annual sales of more than \$21 billion. Every company with such a growth plan runs risks, naturally. Morningstar equities strategist Mark Sellers, who bought the stock for a model portfolio he runs, says one risk CarMax faces is a surge in interest rates. That could create a loss on the loans CarMax makes and holds briefly before selling into the secondary market.

Yet with the stock near \$19, the risks in CarMax seem tolerable. Primecap Management, whose Vanguard Primecap Fund has beaten the Standard & Poor's 500-stock index by an annual average of 2.5 percentage points since 1984, has built a 7% stake in the stock this year. CarMax insiders also have been recent buyers. Like riding in a fast car on a curvy road, most growth stocks make me queasy. Not this one. ■

E-mail: rb@businessweek.com



BY MARA DER HOVANESIAN

THE BIG SELL-OFFS MAY BE OVER AT **MANPOWER** AND **MONSTER**.

AIRLINES CALL ON **B/E AEROSPACE** TO SPRUCE UP THEIR PLANES.

ANGIOTECH'S STENT-COATING TROUBLES COULD BE SHORT-LIVED.

Higher Counts on Hires?

EMPLOYMENT STOCKS hit the skids after the Bureau of Labor Statistics released a weak job report for July and lowered the already disappointing figures for June.

Manpower (MAN) and Monster Worldwide (MNST) are way off their earlier 2004 highs (table). Some analysts are convinced that the sell-off is overdone. "I worry about how oil prices will impact jobs," says Randall Mehl of investment firm Robert W. Baird. "But the market is ignoring the steady recovery we've had." Profits at Manpower, the world's second-largest staffing company, rose 83% in the second quarter, to \$53.1 million, or 56¢ a share—on revenues of \$3.6 billion, up 20%. That beat the Street's estimates of 52¢, according to Thomson First Call. Although it typically trades at a price-earnings ratio of 20 during a recovery, says Mehl, the stock is hovering at 14 times his "very achievable" 2005 estimate of \$2.70. His 12-month target for the stock, now at 42, is 58. The same prospects could face Net job-search company Monster, first mentioned in this column in May, 2003. Then at 17, the stock jumped to 29 but has since slumped to 20.51. Mehl's current target is 32. "Lower jobless claims and fewer layoffs give me confidence that we are still creating a material number of jobs," adds analyst Marta Nichols of Banc of America Securities: She pegs Manpower at 55 and Monster at 30.

EMPLOYMENT SERVICES

COMPANY	CURRENT PRICE	52-WEEK HIGH/LOW	12-MONTH TARGET
MAN	42.00	51/37	58
MNST	20.51	29/18	32

Data: Bloomberg Finance Markets; Robert W. Baird & Co.

This Aircraft Outfitter May Weather the Storms

THE WAY AIRLINES are headed these days, investing in any related stocks seems like buying a one-way ticket to nowhere. All the big carriers—Delta, United, American, US Airways—will probably post huge losses this year. Still, that doesn't mean carriers can neglect sprucing up cabins or keeping equipment up to date. Upgrades to interiors—seats, food-and-beverage preparation gear, and oxygen-delivery systems—is the specialty of B/E Aerospace (BEAV). "Airlines, if they want to be competitive, can only put off retrofitting and refurbishment for so long," says Alex Gould of Criterion Research Group. He says there's pent-up demand for B/E's services. If so, the Wellington (Fla.) company could see an

earnings rebound. It last earned a profit in 2001: \$20 million, on revenues of \$666 million. This year's second-quarter sales of \$185 million, however, represent year-over-year growth of 22%. Net losses narrowed to \$2.4 million, or 6¢ per share, compared with 39¢ last year. Gould says the stock, now at 11, could hit 17 in 6 to 12 months. Adam Weiner of Credit Suisse First Boston cautions that the volatility of oil poses serious risks, particularly with B/E's highly leveraged balance sheet. Nonetheless, he recently increased his 2005 earnings estimate from 30¢ a share to 40¢—and foresees 80¢ in 2006, based on sales growth of 10% and a 16% increase in operating income.

A SHARP UPDRAFT

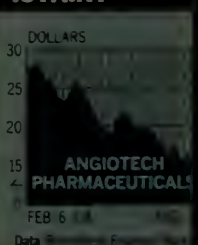


Ready To Rebound At Angiotech

BOSTON SCIENTIFIC's July 2 recall of its drug-coated stents has sent shares tumbling 17%. Some analysts call it a buying opportunity. And, they say, little-known Angiotech Pharmaceuticals, a specialty outfit in Vancouver, may be an even better bet. Angiotech, now trading at 17.51, licenses its stent-coating technology to Boston Scientific, and analyst Ashkan Haghighat of BMO Nesbitt Burns is upbeat about its cutting-edge technology. He initiated coverage on Aug. 12 with a 12-month price target of 23. Jayson Bedford at investment outfit Adams Harness calls the company a pioneer in drug-coated medical devices and says the current valuation doesn't account for its deep pipeline of key patents. The stock has a p-e ratio of 23, based on his 2005 earnings estimate of 86¢. His conservative price target is 20. Another plus: Angiotech holds cash of \$3 a share. ■

Gene Marcial will be back next week.

THE PULSE IS FAINT



BusinessWeek online

Gene Marcial's Inside Wall Street is posted at businessweek.com/today.htm at 5 p.m. EST on the magazine's publication day, usually Thursdays. See Gene on Fridays at 1:20 p.m. EST on CNN's *The Money Gang*.

Note: Unless otherwise noted, neither the sources cited in Inside Wall Street nor the firms hold positions in the stocks under discussion. Similarly, they have no investment banking or other financial relationships with them.

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EXCEPT WHERE YOU'RE GOING.



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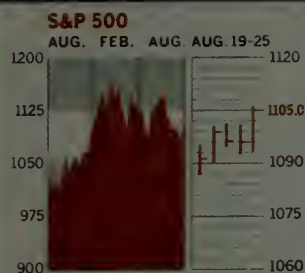


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STOCKS



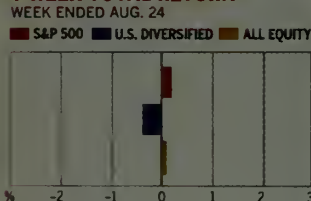
COMMENTARY

The market broke out of its recent gridlock this week, with stocks advancing across the board. The tech-heavy NASDAQ led the way, rising 1.6%, as investors cautiously nibbled at such beaten-down stocks as Intel and Microsoft. Meanwhile, the Dow lifted 1.0% on the wings of plane-maker Boeing, where bookings for new jets surged. The caveat? Volume remains light.

Data: Bloomberg Financial Markets, Reuters

MUTUAL FUNDS

4-WEEK TOTAL RETURN



52-WEEK TOTAL RETURN



Data: Standard & Poor's

U.S. MARKETS

	AUG. 25	WEEK	% CHANGE YEAR TO DATE	LAST 12 MONTHS
S&P 500	1105.0	0.9	-0.6	11.2
Dow Jones Industrials	10,181.7	1.0	-2.6	9.3
NASDAQ Composite	1860.7	1.6	-7.1	5.5
S&P MidCap 400	575.9	1.2	0.0	13.9
S&P SmallCap 600	278.3	1.2	2.9	16.8
DJ Wilshire 5000	10,736.5	1.0	-0.6	12.0

SECTORS

	AUG. 25	WEEK	% CHANGE YEAR TO DATE	LAST 12 MONTHS
BusinessWeek 50*	630.5	0.9	1.3	10.3
BW Info Tech 100**	324.3	2.0	-7.5	4.7
S&P/BARRA Growth	540.1	0.8	-2.8	7.2
S&P/BARRA Value	560.8	1.0	1.6	15.3
S&P Energy	249.3	0.4	11.2	27.0
S&P Financials	386.2	1.3	1.7	14.6
S&P REIT	126.0	1.9	8.8	22.7
S&P Transportation	201.5	1.9	-0.2	13.5
S&P Utilities	125.2	-0.2	5.8	18.8
GSTI Internet	140.6	3.5	-2.8	6.6
PSE Technology	662.3	1.7	-5.0	7.4

*Mar. 19, 1999=1000 **Feb. 7, 2000=1000

GLOBAL MARKETS

	AUG. 25	WEEK	% CHANGE YEAR TO DATE	LAST 12 MONTHS
S&P Euro Plus (U.S. Dollar)	1123.1	-0.5	-4.7	1.1
London (FT-SE 100)	4411.6	1.3	-1.5	4.1
Paris (CAC 40)	3595.3	1.5	1.1	6.1
Frankfurt (DAX)	3788.9	1.7	-4.4	8.1
Tokyo (NIKKEI 225)	11,130.0	3.3	4.2	7.1
Hong Kong (Hang Seng)	12,793.0	4.6	1.7	1.1
Toronto (S&P/TSX Composite)	8371.4	1.8	1.8	11.1
Mexico City (IPC)	10,237.9	1.6	16.4	3.1

FUNDAMENTALS

	AUG. 24	WEEK AGO	YEAR AGO
S&P 500 Dividend Yield	1.73%	1.73%	1.66%
S&P 500 P/E Ratio (Trailing 12 mos.)	19.4	19.2	28.0
S&P 500 P/E Ratio (Next 12 mos.)*	16.0	15.8	17.0
First Call Earnings Revision*	0.06%	0.08%	-0.20%

TECHNICAL INDICATORS

	AUG. 24	WEEK AGO	REAR
S&P 500 200-day average	1110.4	1109.3	Negati
Stocks above 200-day average	50.0%	45.0%	Neutr
Options: Put/call ratio	0.82	0.82	Positi
Insiders: Vickers NYSE Sell/buy ratio	2.92	2.96	Negati

BEST-PERFORMING GROUPS

	LAST MONTH %		LAST 12 MONTH %
Internet Retail	14.2	Internet Software	83.2
Gold Mining	12.9	Steel	68.8
Homebuilding	12.5	Oil & Gas Refining	60.9
Photographic Products	11.8	Wireless Services	58.3
Divsfd. Metals & Mining	9.0	Internet Retail	53.6

WORST-PERFORMING GROUPS

	LAST MONTH %		LAST 12 MONTH %
Food Wholesalers	-8.9	Semiconductor Equip.	-2.1
Health-Care Distribtr.	-7.7	Airlines	-1.1
Health-Care Services	-7.5	Health-Care Distribtr.	-1.1
Health-Care Facilities	-7.2	Semiconductors	-1.1
Divsfd. Commercial Svcs.	-6.7	IT Consulting	-1.1

EQUITY FUND CATEGORIES

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		LEADERS	
Real Estate	7.5	Latin America	35.0
Precious Metals	7.1	Real Estate	29.5
Latin America	5.0	Natural Resources	28.8
Utilities	2.8	Europe	24.4
LAGGARDS		LAGGARDS	
Technology	-2.2	Technology	-3.2
Small-cap Growth	-1.6	Small-cap Growth	4.6
Natural Resources	-1.6	Mid-cap Growth	4.8
Mid-cap Growth	-1.2	Large-cap Growth	4.8

EQUITY FUNDS

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		LEADERS	
ProFds. Pr. Mtl. Ustr. Inv.	13.7	American Heritage	66.7
ProFds. Rl. Est. Ustr. Inv.	12.7	ProFds. Wriss. Ultsr. Inv.	63.1
PIMCO Real Est. Instl.	12.1	iShares MSCI Austria Idx.	59.3
iShares MSCI Brazil Index	10.4	Bruce	55.7
LAGGARDS		LAGGARDS	
Wasatch Ultra Growth	-9.1	Ameritor Investment	-32.4
ProFds. Smicdr. Ultsr. Inv.	-8.5	ProFds. Smicdr. Ultsr. Inv.	-31.9
Apex Mid Cap Growth	-7.6	Grand Prix A	-28.0
Perkins Opportunity	-7.4	Thurlo Growth	-24.0

INTEREST RATES

KEY RATES

	AUG. 25	WEEK AGO	YEAR AGO
Money Market Funds	0.99%	0.96%	0.96%
90-Day Treasury Bills	1.54	1.47	0.99
2-Year Treasury Notes	2.44	2.42	4.51
10-Year Treasury Notes	4.26	4.24	4.51
30-Year Treasury Bonds	5.04	5.04	5.04
30-Year Fixed Mortgage†	5.80	5.79	6.4

†BanxQuote.

BLOOMBERG MUNI YIELD EQUIVALENTS

Taxable equivalent yields on AAA-rated, tax-exempt municipal bonds, assuming a 30% federal tax rate.

	10-YR. BOND	30-YR. BOND
General Obligations		
Taxable Equivalent	5.17	6.6
Insured Revenue Bonds		
Taxable Equivalent	5.46	6.9

THE WEEK AHEAD

PERSONAL INCOME Monday, Aug. 30, 8:30 a.m. EDT » Personal income is forecast to have grown by 0.4% in July, following a 0.2% gain in June. That's based on the median forecast of economists surveyed by Action Economics. Consumer expenditures probably rebounded by 0.7%, after a 0.7% fall in June.

CONSUMER CONFIDENCE Tuesday, Aug. 31, 10 a.m. EDT » The Conference Board's

August confidence index most likely fell to 104, from 106.1 in July.

PURCHASING MANAGERS' INDEX Wednesday, Sept. 1, 10 a.m. EDT » The Institute for Supply Management's August factory activity index probably slipped to 60%, from 62% for July.

FACTORY INVENTORIES Thursday, Sept. 2, 10 a.m. EDT » A good gain in July factory output suggests manufacturing inventories rose 0.4% last month.

In June, inventories climbed 0.7%.

EMPLOYMENT Friday, Sept. 3, 8:30 a.m. EDT » Nonfarm payrolls probably grew by 150,000 in August, after a tepid gain of 32,000 in July. But Hurricane Charley may affect the August results. Factory payrolls most likely expanded at a moderate pace of 13,000 jobs, after a gain of 10,000 in July. The improvement in job growth probably kept the unemployment rate at 5.5%.

The BusinessWeek production index improved to 224.7 for the week ended Aug. 14, a 12.7% increase from the previous year. Before calculation of the four-week moving average, the index held steady at 224.7.

BusinessWeek **online**

For the BW50, more investment data, and the components of the production index visit www.businessweek.com/magazine/extra

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This index gives the starting page for a story or feature with a significant reference to a company. Most subsidiaries are indexed under their own names. Companies listed only in tables are not included.

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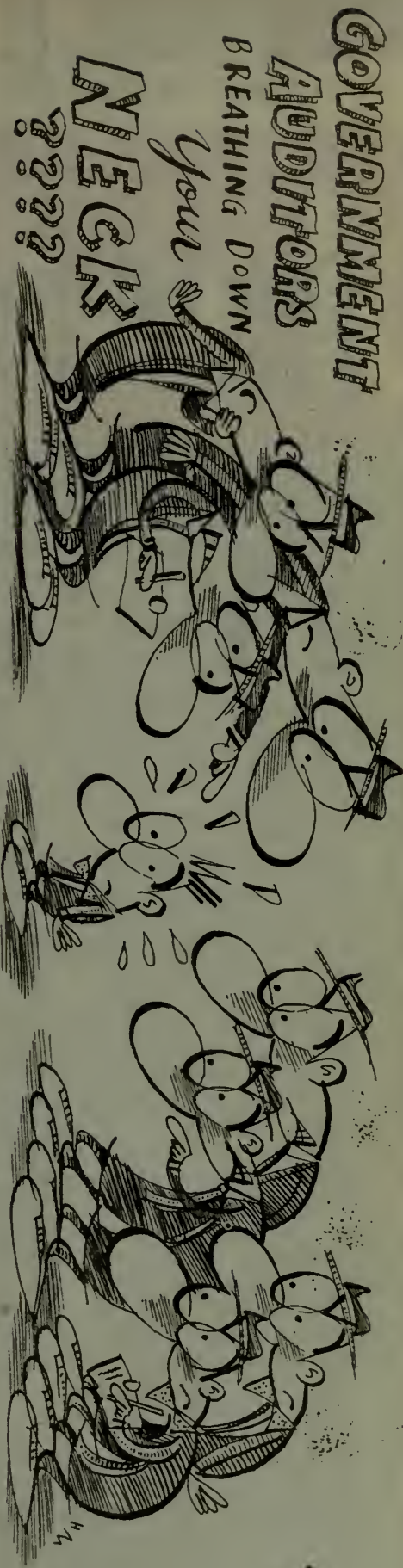
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Our Take on the GOP's Economic Plans

AS THE REPUBLICAN party begins its convention in New York City, the Bush Administration is busy shaping the domestic economic policy package it will take to voters in November. President George W. Bush is likely to offer a vision of an Ownership Society in contrast to the "middle-class squeeze" message by Democrat John F. Kerry. Campaign advisers are proposing a variety of plans for Bush to include in that vision (page 34). Here is our take on several key GOP economic ideas. It favors pragmatic solutions over political partisanship and centrist positions over extreme ideology.

HEALTH. The rising cost of health care is perhaps the most pressing issue in America today. Sky-high medical costs are slowing job growth, blind-siding the retired, and overwhelming families everywhere. One campaign proposal to expand existing Health Savings Accounts is a good idea that President Bush is planning to roll out. HSAs allow people to contribute money to a tax-free account that can be used for out-of-pocket health-care expenses if they buy high-deductible health insurance policies to cover catastrophic expenses. The new idea from the Bush campaign is to let people deduct the cost of the premiums they pay to buy such policies. HSAs can reduce insurance reimbursement costs to doctors because patients pay them directly. And by also paying for drugs and lab tests, people are more likely to shop around for generics and lower-cost labs. HSAs are a winner for Bush.

SOCIAL SECURITY. But pushing private Social Security retirement accounts is not. Advocates in the campaign want to permit employees to put 2 percentage points of the 12.4% Social Security payroll tax into private accounts. Yet unlike the health system, Social Security isn't broken. Forecasts of its demise are based on unrealistically low economic growth estimates. As these are raised year after year, the eventual bankruptcy of the Social Security trust fund gets pushed further and further back. The Congressional Budget Office now estimates it will hit empty in 2052, long after most boomers are dead. Even that is based on low estimates of productivity and growth. If current levels are sustained, Social Security could be available for the boomers and their kids. The drive to do away with this safety net is

based on ideology, not economics.

TAXES. The campaign priority is to continue the march toward a tax code that exempts savings and investments while reducing taxes on income. The first goal is to make permanent Bush's 2001 and 2003 cuts on income, capital gains, dividend and estate taxes. The second is to offer additional new Retirement and Lifetime Savings Accounts. But rising budget deficits make this problematic. Just keep tax rates essentially where they are now and paying for the new Medicare drug benefit and fixing the alternative minimum tax (AMT) will add nearly \$3 trillion to the existing budget deficit.

To pay for this, some in the Republican Party are suggesting a radical shift of the tax code to either a flat tax or a retail sales tax levy. The country isn't nearly ready for this kind of radical change. Better for Bush to make some hard choices among his tax initiatives. Maintaining the capital gains and dividend taxes at 15% are clear pro-savings, pro-investment, and pro-growth policies. But

Health Savings Accounts are a winner; 'fixing' Social Security isn't

eliminating all estate taxes is excessive and expensive. Allowing individuals, businesses, and farmers to retain up to \$5 million in the estates and dropping the top rate to 30% from 55% makes the estate tax fairer and saves money. And since the income tax cuts aren't scheduled to expire until 2008, taxpayers will benefit over the next four years without any action. This preserves some fiscal flexibility

to deal with a possible budget deficit crisis in the future.

SPENDING. There are crosscurrents within the Bush campaign about curbing government spending, and the President would do well to take note. Cutting multi-billion dollar farm subsidies makes both fiscal and economic sense. Revamping the ill-advised Medicare drug benefit could save more billions. And tackling such egregious pork barrel projects as the highway bill could free up big sums to help pay for more important pro-growth tax cuts.

Bush's vision of an Ownership Society could have broad appeal to voters. It offers them a sharp contrast with Kerry's own vision of government help for an overburdened middle class. But most Americans will insist that either vision be fair, equitable, and practical before they buy into it. That's the campaign challenge for President Bush when he steps the podium on Thursday to ask for a second term.



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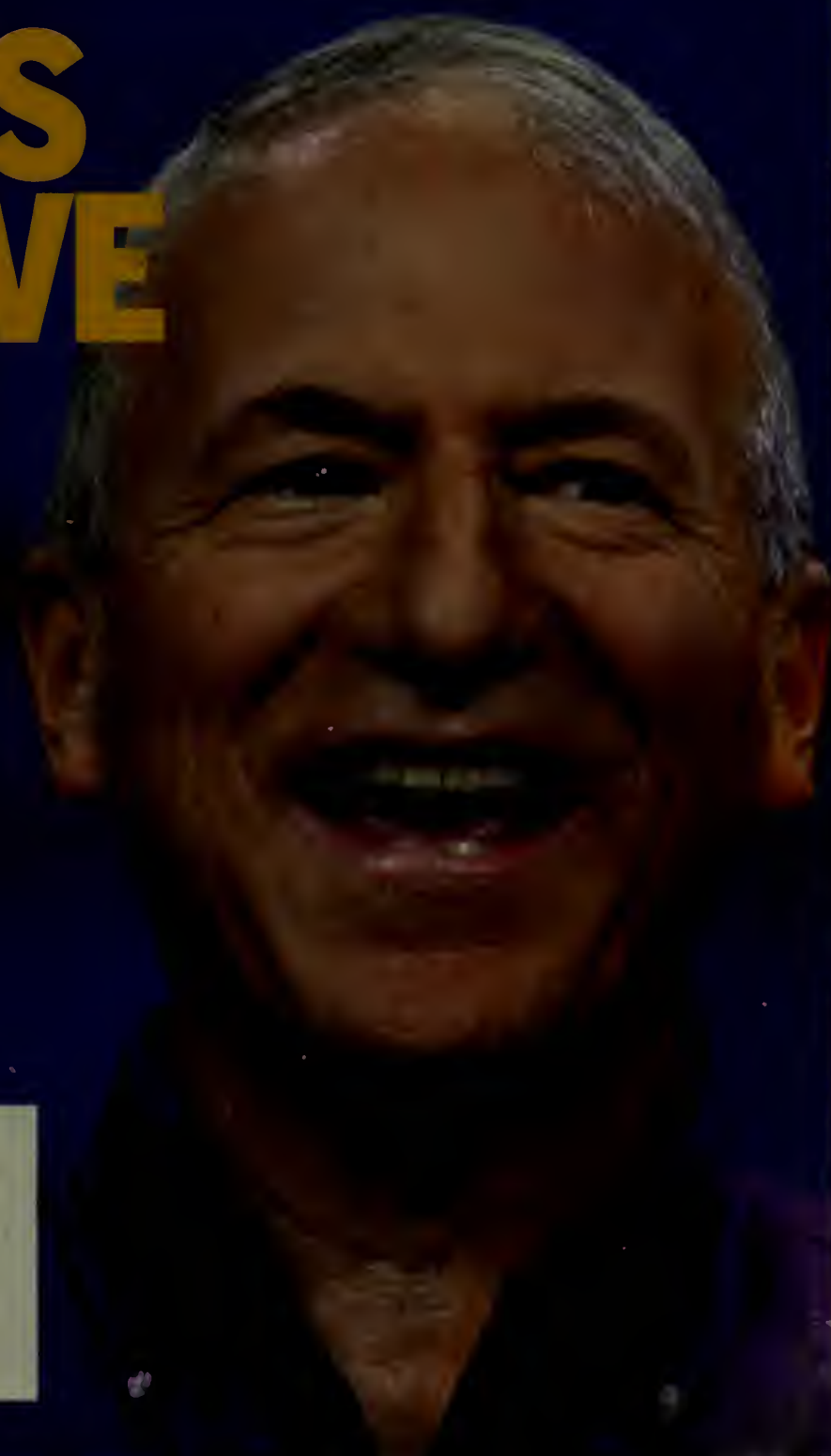
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CAN THIS MAN SAVE LABOR?

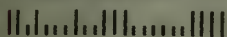
Service Employees
President **Andy Stern**
has radical plans to
make the U.S. labor
movement. Will
other union leaders
go along?

BARON BERNSTEIN (P.80)



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ALL TOGETHER NOW
Service employees' chief Andy Stern (bottom right) at the union's annual conference in June



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Gates & Co. are taking it on



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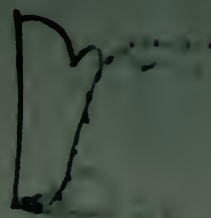
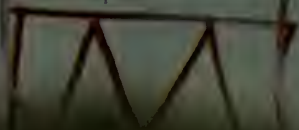
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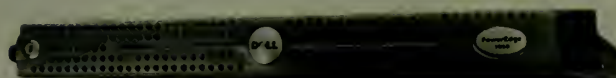


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When it came to our tasting of "white goods," the superpremiums ruled the day. Here, our top three in each category, plus our tasters' comments:

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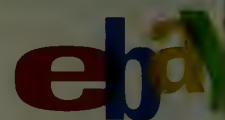
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eBay: The Perfect Market, Or Not Worth the Effort?



For some, the online auctioneer brings the full thrill of the hunt to the Internet. But for others, a good deal at a fixed price is a better bet. Competing commentaries argue each way on eBay

Apple's New iMac: Skin-Deep Beauty

Apple has finally pulled back the curtain on the newest version of its consumer desktop. The sleek design could provide an alternative vision for future PCs, but if you want sweeping technical innovation, or even adequate memory, it falls short

Hewlett-Packard's New Target: Couch Potatoes

The tech giant is diving head first into consumer electronics—from plasma TVs to an HP branded iPod. A big success will go a long way toward vindicating CEO Carly Fiorina's vision. But if it flops...



FedEx Keeps on Truckin'

Standard & Poor's Jim Corridore sees the world's second-largest express-delivery company pulling even with UPS in terms of valuation. S&P likes its expanding international operations and expects the Kinko's acquisition will add to the bottom line

South Koreans to Roh: What's the Plan?

The President's policy zigzagging and furious confrontations over the past threaten to polarize and paralyze the country at a key moment



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JP Front

"To those critics who are so pessimistic...I say: Don't be economic girlie men."

—California Governor Arnold Schwarzenegger at the Republican National Convention

EDITED BY BRIAN HINDO

TECH-QUISITIONS

BOMBING ISRAEL FOR TREASURE

AFTER A LONG drought, a power of deals is reviving Israel's Silicon *wadis*—the collective term for the 12 high-tech industrial parks scattered around the country. Aug. 25, **Cisco** announced it had paid \$200 million for **P-Cube**, a Tel Aviv developer of work-traffic-management software co-founded by Giora Shalev. This is the company's second Israeli acquisition in three months, helping its roster of acquisitions in the country up to ten. "[The Israelis] have a very strong tradition of



SUDDENLY CISCO
P-Cube's Chairman Yaron

innovation in engineering," says Ned Hooper, senior director of corporate development for Cisco.

Cisco is not the only high-tech heavyweight sifting the sands for opportunities. The country is chock-full of startups developing cutting-edge software, medical devices, and networking infrastructure for the Web. Now many are ripe for the picking.

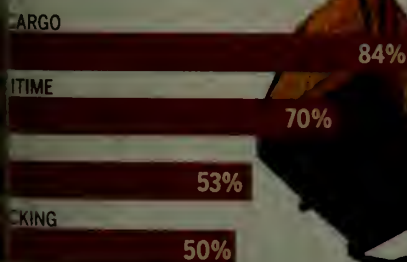
Israeli venture-capital funds, meanwhile, are restocking their coffers: Industry experts predict local outfits will raise over \$1 billion this year, with most of the funds coming from

American and European institutional investors. The *wadis* certainly could use the rain.

—Neal Sandler, with Peter Burrows

THE BIG PICTURE

SKY BUSINESS The percentage of transportation executives in key sectors who say they face high security risks in their business:



Deloitte & Touche LLP survey of 103 senior executives at cargo and transportation providers, finishing May 15, 2004



EDIBLE WEB

FreshDirect Keeps on Truckin'

THE ONLINE GROCERY business is littered with failures—notably **Webvan**, which raised \$1 billion before collapsing in 2001. At New York startup **FreshDirect**, too, overaggressive marketing and service problems led to smashed tomatoes and red ink. But a management shakeup could lead it to profitability.

On Sept. 8, FreshDirect will tap Dean Furbush as CEO, *BusinessWeek* has learned. Furbush, a former vice-president of **NASDAQ Transaction Services**, joined as COO last winter, a few months before flamboyant co-founder Joseph Fedele stepped down from the top post. Already, Furbush has increased delivery fees and is adding new routes cautiously to concentrate on keeping the company's existing 100,000 customers happy.

FreshDirect's revamped strategy calls for adding a national mail-order service and business catering in New York, while delaying a push into other cities. That contrasts with rivals such as **Peapod** and **Safeway**, which are pursuing national reach. FreshDirect's eventual goal: to grow from around \$120 million in revenues this year up to \$500 million within several years. "We have to make sure we have a consistently positive experience," Furbush says.

That means keeping an eye first and foremost on the tomatoes.

—Heather Green

EXECUTIVE CLASS

A MARKETING HONCHO'S BEST FRIEND

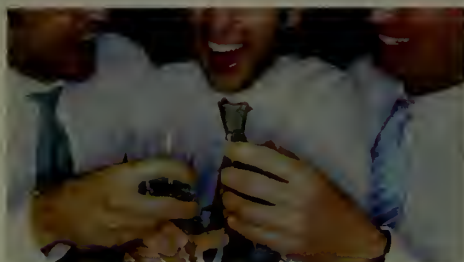
EXECUTIVE SEARCH FIRM

Spencer Stuart's G100 group is the über-exclusive club for the CEO set, hooking up chiefs from 100 top U.S. multinationals to exchange ideas. Now, ex-Spencer Stuart

club is called, allows just one member from any industry in order to encourage discussion—free from competitive pressure—of issues such as the death of mass marketing. Despite a \$50,000 annual fee—same as the G100—Smith's Atlanta firm, **World 50**, sold out spots in just a few months. With an average tenure of just 22 months, CMOs "are scared, lonely, and can't go asking the CEO for advice," he says.

Members get twice-yearly meetings, conference calls, and access to research from partners such as ad agency WPP. "What a find," raves Kodak CMO Carl Gustin Jr. Smith plans to create similar groups for chief financial officers and heads of international operations.

—Dean Foust



recruiter Rick Smith hopes for similar success

JOINERS The club for CMOs filled up fast

with chief marketing officers from 50 companies, such as **General Electric** and **Kodak**.

The Marketing 50, as the

STRAPPED Buenos Aires' National Congress Building



CITY LIFE

PERMANENT COLLECTIONS Paris has the Louvre, Madrid has the Prado, and Buenos Aires has...the Museum of Foreign Debt. Set open in January, the institution will document Argentina's habit of living beyond its means, from its first default in 1827 to its \$141 billion default in 2001, the largest ever by any nation. "The museum will help ordinary people who are hurt by the debt issue but don't understand the technical details," says head curator Simón Pristupin, professor of economics at Buenos Aires University, which will house the museum. Funding for the project has been hard to snag though. Why? The city government itself is heavily in debt.

—Colin Barraclough

MEDIA MANIA

NETWORK TV: IN NEED OF A FACELIFT

TV BROADCAST networks are going gray. The median age of a prime-time viewer at **ABC, CBS, NBC, Fox, UPN**, and **WB** rose from 44.1 in 2000 to 45.7 in 2004, according to media researcher **Magna Global USA**. That's faster than the uptick in the median age for prime-time TV viewers overall, which budged from 36.5 to 37.2 in the same period.

The numbers show cable TV siphoning off the younger viewers so precious to advertisers. So how are the nets planning to lure them back? How else? More reality shows.

—Brian Hinde

DRAWN & QUARTERED



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FACE TIME

JIM BUCKMASTER



CAN CRAIGSLIST STAY COOL?

When eBay bought 25% of craigslist on Aug. 14, some fans of the online classifieds site cried sellout. After all, with a homey informality, spartan design, and no ads, craigslist's cult-like following of 5 million visitors per month call it the anti-eBay.

But shy-guy CEO **Jim Buckmaster**, 42, insists the listings—where you can find a job, a house, or a Friday-night date—won't change. He's personally invested: gregarious founder **Craig Newmark** hired Buckmaster after seeing the ex-programmer's résumé on craigslist in 1999. Since then, the site's revenues from job listing fees have increased to an estimated \$7 million in 2003 and expanded the Bay Area-based list to 45 cities.

As for eBay, Buckmaster says a former craigslist employee sold out his equity stake to the dot-com giant, which is eager to get in on the market for online classifieds. Ideally, says Buckmaster, "we'd have [had] the finances to buy him out ourselves." In any event, he'll have the cult of craigslist to keep him on target. —*Jessi Hempel*

PRODUCT PEEK

BYE, HONEY, GOTTA FLY TO THE OFFICE

GEORGE JETSON made getting to work look so easy. The 1960s cartoon character would simply hop into his flying car, which would whisk him off to the office. For the rest of us, traffic jams are part of daily life. But that may change in the not-too-distant future.

Thanks to advances in computing, materials, and robotics, several startups have developed flying car prototypes. **Haynes-Aero**, **Moller International**, and **Trek Aerospace** are hatching vehicles ranging from a personal helicopter to a car that runs on the road but sprouts wings at the push of a button. Early versions could be put to use by U.S. soldiers to swoop in and out of urban combat zones.

Recent efforts from some big companies could help pave the way for commercial-

ization of small flying craft. **Honda** has designed an experimental air taxi: a small, cost-efficient plane to ferry four or five passengers between small airports. **General Electric** is helping build the plane's economical jet engine. The startups are hoping that Honda's involvement in taxicabs for the air prepares the marketplace—and the government—for widespread personal use of the skies.

That's essential because flying cars would require an overhaul of air traffic regulations just to get off the ground. Another problem:

The vehicles require more tinkering to ensure they would be reliable and as easy to pilot as automobiles.

Still, the nascent industry is attracting the interest of venture capitalists. Timothy Draper, founder of Silicon Valley venture-capital firm **Draper Fisher Jurvetson**—which launched online advertising company **OvertureServices**—has solicited proposals from those developing flying cars. Who knows: It may not be long before you and your carpool buddies travel like George and Jane Jetson. —*Olga Kh*



VOX POPULI

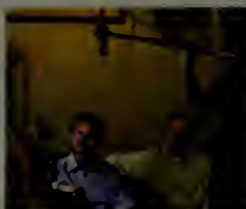
OFFSHORING: SEE THE MOVIE, READ THE BOOK

THE ANGRY, big-issue documentary is having a vintage year. Making the biggest splash by far is *Fahrenheit 9/11*, Michael Moore's anti-Bush broadside. And a pair of feature-length films have taken aim at the behavior of Big Business: *The Corporation*, co-directed by Mark

Achbar and Jennifer Abbott, and Morgan Spurlock's blast at **McDonald's**, *Super Size Me*.

Now comes *American Jobs*, by freelance **MTV** producer Greg Spotts. After several pals were laid off, he turned his lens to unemployed workers whose jobs had traveled abroad. The film debuts on Sept. 9 in

Kannapolis, N.C., where Spotts interviewed displaced workers. Fans can follow up by reading **CNN** anchor Lou Dobbs's new anti-offshoring book, *Exporting America*. —*Lauren Gard*



CUT! An interview from *American Jobs*

THE STAT

34

The percentage of men's clothing purchased for them by the women in their lives. The figure is down from 70% in 1985—how's that for progress?

Data: NPD Group



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As part of its anniversary celebration, BusinessWeek is presenting a series of weekly profiles of the greatest innovators of the past 75 years. Some made their mark in science or technology; others in management, finance, marketing, or government. In late September, 2004, BusinessWeek will publish a special commemorative issue on Innovation.

Birth Control Of a Nation

FROM THE 1920s to the 1950s, thousands of despairing young mothers wrote letters to America's first birth-control champion, Margaret Sanger. They were women like Sadie Sachs, who had three kids and a trucker husband named Jake. When Sadie pleaded with her doctor to give her something, anything to

prevent another baby, the physician quipped: "Tell Jake to sleep on the roof." After Sachs got pregnant again, she induced an abortion, only to die from the resulting septicemia.

This was an America where buying a single condom made you a criminal in 30 states; where priests told women who used black-market diaphragms that they would be haunted by the faces of their unborn children; and where some women like Sanger's devoutly Catholic mother, who got pregnant 18 times and had 11 children and 7 miscarriages, died an early death from the ravages of so many births. Born in Corning, N.Y., in 1879, Sanger was determined to forge a different fate for herself, scrounging the money to go to nursing school.

Furious at the fortunes of women like her mother, Sanger, who started her career as an obstetrical nurse on New York's Lower East Side, founded the Planned Parenthood Federation of America (her first attempt at opening a clinic in Brooklyn, in 1916, ended with a police raid). Her greatest achievement, though, was in spearheading the effort to create America's first nearly foolproof oral contraceptive. Sanger enlisted MIT-educated heiress Katharine D. McCormick, the philanthropist who went on to fund the scientific research team of biologist Gregory Pincus, physiologist M.C. Chang, and Harvard Medical School doctor John Rock—though others also had a hand in the pill's development.

Some social historians claim that more than the atomic

**Sanger
founded
Planned
Parenthood
and was an
early power
behind the pill**



bomb, the airplane, or the Internet, it was this tiny pill that exerted a mythic transformation on 20th century society, redistributing power in the bedroom, the classroom, and the workplace. To women, it opened up the possibility that they could choose when, how, and if to have children, careers, or marriages. Indeed, the pill helped create a nation in which women now vastly outnumber men in college and graduate degrees; where one-third of wives outearn their husbands; and where 14 female Senators now craft public policy in Washington.

For all that Planned Parenthood and the pill achieved, though, Sanger has also been disparaged. Her interest in eugenics—which aimed to cap breeding by "inferior" humans (nonwhites, the disabled, and the insane)—inflamed critics, as did her support of the controversial 1950s pill trials in Puerto Rico, in which poor women were given dangerous, sometimes fatal doses.

When the pill was finally approved by the Food & Drug Administration in 1960, Sanger was a somewhat forgotten 80-year-old widow living in Tucson. She celebrated the new by uncorking a bottle of champagne and sipping it alone. In her remaining years, biographers claim Sanger grew increasingly embittered. After a life filled with political intrigue, jailings, two marriages, three children, and a slew of racy love affairs, including one with H.G. Wells, Sanger died in 1966. Twenty-five years later, nearly 80% of American women had tried the pill. ■

—By Michelle Co

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imagination at work

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U.S. scientists, engineers, and manufacturers have managed to improve [U.S.] energy efficiency by 46% in the past three decades."

—Mark Whitenton
 National Association of Manufacturers



HOW BUSINESS IS TAKING GLOBAL WARMING SERIOUSLY

ALTHOUGH "GLOBAL warming" (Cover Story, Aug. 16) overstates the certainty of the science involved and unfairly describes reputable climatologists with serious doubts as "naysayers," it nonetheless makes clear that private industry is already taking considerable steps toward a cleaner, more efficient energy future without coercion from politically driven Washington mandates.

As discomfiting as the reality may be to some, we simply will not be in a position to drastically reduce our dependence on fossil fuels for at least the next 15 to 20 years. Insisting this isn't so and enacting command-and-control legislation would only force U.S. companies to unilaterally disarm in the face of unprecedented global economic competition. Moreover, it would impede the future economic growth that will make additional environmental improvements possible.

U.S. scientists, engineers, and manufacturers have managed to improve America's energy efficiency by 46% in the past three decades. If left to their own devices, they will continue to move our

economy and environment ahead in the 21st century.

—Mark Whitenton
 Vice-President, Resources
 & Environmental Policy
 National Association of Manufacturers
 Washington, D.C.

YOUR ARTICLE MAKES A powerful call for action by government and big business but doesn't mention small business which now constitutes one-half of the economy. As such, small business consumes one-half of all energy used for commercial and industrial purposes. One-third to one-half of all the energy consumed by small business is wasted through inefficiency. Small businesses can profit immensely by making investments in energy efficiency.

Unlike the exotic future technology being proposed for big business—"clean coal," carbon sequestration, hydrogen-powered cars, etc.—small-business energy efficiency can be achieved through available technologies. Restaurants, for example, can increase profits by investing in energy-efficient commercial refrigerators and freezers that cut energy use in half.

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But most small-business owners lack the money, information, and time to explore their options for energy efficiency. What's needed is a mechanism that makes those options as easy as falling off a log. One such mechanism exists: On-Bill Financing (OBF), which is a utility-used method that provides no-cost financing for energy efficiency upgrades through the monthly power bill that all businesses pay. Three successful programs are now operating in New England.

—Byron Kennard
Executive Director
Center for Small Business
& the Environment
Washington, D.C.

NEW YORK MAJOR U.S.-based corporations lag on the issue, behind their competitors in Europe and Japan. Indeed, there are still many executives in major U.S. corporations in the automotive and electronics industries who have yet to recognize that their attitudes and inaction on global warming are short-sighted and strategically unwise as well as socially irresponsible. Perhaps your cover article and editorial will help them to see the future and their interests and responsibilities more clearly.

—Thomas L. Brewer
Associate Professor
Georgetown University
McDonough School of Business
Washington, D.C.

WE HAVE WITNESSED firsthand the determined work of companies that take global warming seriously. Just a few months ago, we helped 25 energy companies, representing about 30% of the utility industry, launch the PowerTree Carbon Co., a multimillion-dollar carbon sequestration initiative that will reforest six projects in the lower Mississippi Alluvial Valley in Louisiana, Mississippi, and Arkansas with enough hardwood trees to eventually capture more than 2 million tons of carbon dioxide from the atmosphere.

The benefits: Over a 100-year period, each acre of new forest will absorb about 10 tons of carbon dioxide, which plants pull from the air to convert to energy for growth. Under reforestation programs, carbon can be sequestered at approximately one-tenth the cost of reducing emissions through technological solutions, such as smokestack scrubbers.

—Lawrence Selzer
President and CEO
Conservation Fund
Arlington, Va.

I WOULD LIKE to emphasize the role of agriculture in global warming. Climate change could not only have negative impacts on crop yields and the availability of water for irrigation, but it could also increase soil erosion, air and water pollution, pests and diseases, and ultimately create disruptions in the safety and security of the world's food supply.

But agriculture is also an industry that has great potential for positively affecting climate change. Opportunities exist for the development and commercialization of agricultural technologies that mitigate greenhouse gas emissions, such as anaerobic digestion of manure, as well as practices that can sequester atmospheric carbon in the soils, such as reduced tillage. Many of these practices have additional benefits, such as soil conservation, improved fertility, and value-added products. In addition, agricultural biomass can be used to displace a variety of fossil-fuel-based energy products, such as plastics. That keeps American energy dollars at home and creates new value-added products to benefit farmers.

—Chad Kruger
Director of Outreach
Climate Friendly Farming
Wenatchee, Wash.

THE UNSPOKEN CONSENSUS in much of the energy community is that you cannot address global warming without substantial additions of nuclear energy. Efficiency improvements have lowered operating costs to those below coal-burning. We're ready for advanced nuclear plants, already being built overseas. It's in all our best interests to help make nuclear power one of the central, zero-emissions energy sources of the coming decades.

—William H. Miller
Professor
Nuclear Science & Engineering Institute
University of Missouri
Columbia, Mo.

INVESTORS, PARTICULARLY long-term institutional investors, have begun to work together to demand a response to warming commensurate with the risks it poses. While companies such as Cinergy Corp. and American Electric Power Co. are rightly lauded for taking steps to reduce their carbon emissions, they did so in large part because the Coalition for Environmentally Responsible Economics (CERES), the Carbon Disclosure Project, the Interfaith Center on Corporate Responsibility, and others organized trillions of dollars of investor capital to pressure management to take action.

Shareholder resolutions on the legal and financial risks associated with warming are being brought and supported by increasingly well-organized institutional investors—and are receiving a larger share of votes than anyone thought possible just three years ago. Foundations are playing a dual role. As large shareholders themselves, they're filing resolutions, voting their proxies, helping to organize other institutional investors, and meeting directly with management. And foundation grants are helping to shape corporate response to warming—such as informing management about risks. The message to managers? You can no longer count on the silent support of large investors when it comes to global warming.

—Lance E. Lindblom
President and CEO
Nathan Cummings Foundation
New York

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Nice Dream If You Can Live It

THE EUROPEAN DREAM How Europe's Vision of the Future is Quietly Eclipsing the American Dream

By Jeremy Rifkin; Tarcher/Penguin; 434pp; \$25.95

Kick back, stressed-out Americans, and imagine a world where people “work to live, rather than live to work.” A land where paid vacations, maternity leave, and access to health care, housing assistance, and continuing education aren’t just perks offered by some employers but rights guaranteed by the

Constitution. How nice to live in a “beacon of light in a troubled world” that “beckons us to a new age of inclusivity, diversity, quality of life, deep play, sustainability, universal human rights, the rights of nature, and peace on Earth.” Imagine all the people, living for today....

O.K., the last line is John Lennon. But everything else is straight out of *The European Dream* by Jeremy Rifkin. The utopia in question is today’s European Union, or at least the world the EU is working to build. Rifkin—globalization guru, Wharton School lecturer, and author of best-seller *The End of Work*—makes a compelling case for the desirability of this vision, which he says is usurping the American Dream as a global ideal. But he is less persuasive in arguing that the European ideal is attainable.

What are these dueling dreams? Put simply, Rifkin says Americans believe in “unbridled opportunity for each individual to pursue success” and that government’s main role is to protect property rights. Americans favor personal and national autonomy and a strong military to guard against outside threats. And they believe immigrants should assimilate into the national culture. By contrast, Rifkin observes, Europeans treasure social forms of wealth, believe government should safeguard communal resources, and that civil and social groups should have equal say with commercial interests. Europeans would influence other nations via diplomacy, international institutions, and financial aid rather than with military coercion. And rather than ethnic assimilation, Europeans favor cultural and linguistic diversity.

By now any Euroskeptic is probably calling for a time-out. Bear in mind that these are ideals: Rifkin admits Europeans are no better than anyone else at always living up to their principles. But the bigger question challenging Rifkin’s thesis is whether the European Dream is economically sustainable. The U.S. has roared back from recession, while growth in most of Euroland is anemic and unemployment remains high. What’s more, Europe’s aging workforce is straining its generous welfare and labor policies.

Rifkin agrees Europe’s demographic shift is serious but

says it can be resolved with more liberal immigration. He disagrees Europe is an underachiever. In fact, he reports, European nations—including Germany and France—are more productive than the U.S., proving these countries “a even better at commerce than we are.” Maybe so. But even a major report I’ve seen on productivity growth—by the European Commission, OECD, World Economic Forum, McKinsey, and the Conference Board—bemoans how Europe is falling behind America. Measured by output per hour worked, U.S. productivity rose 2.6% in 2003. In the EU, the pace slowed to 0.8%, from an already weak 0.9% in 2002.

What gives? Rifkin himself uses Conference Board data noting that while the average U.S. worker produced \$38.8 output per hour worked in 2002, the average German produced \$39.39 and the French worker \$41.85. There are

problems with such a selective use of statistics. For one, this gap narrowed in 2003. Also, the output for the 15 EU nations averaged just \$36.20 last year—compared with \$39.20 in the U.S. And there could be many reasons, other than Rifkin’s suggestion that happier workers are more productive, to explain higher average output in some countries. Unemployment is higher across Europe, points out Conference Board economist Robert H. McGuckin. So perhaps those with jobs have higher skills.

It’s a shame Rifkin fails to fully address the debate, because otherwise *The European Dream* is a fascinating study of the differences between American and European psyches. Surveying centuries of sociology, political philosophy, and

theology, the author traces the evolution of Western values then shows how those values diverged as America became a superpower. He also marshals reams of polling data to show that his dueling dreams are just stereotypes. For example, big majorities of Americans pride in their country, see the culture as superior, and end exporting U.S. values. Some

The big question: Is Europe’s way economically sustainable?

55% of Americans under 30 think they will become rich, and by 6 to 1, believe poverty is due to personal flaws. Europeans differ sharply in these beliefs.

Rifkin also excels at explaining why Europeans are more passionate about the environment, human rights, and promoting peace via collective action. As a globally minded guy, I was persuaded that the European outlook is better suited to an interconnected world. Everything in the European dream world may not be realistic. But it’s a wonderful ideal. ■

—By Pete Eng





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BY STEPHEN H. WILDSTROM

An Eager—If Imperfect—Research Assistant

Google and other search tools are wonderful research aids. But if you're writing a report in, say, Microsoft Word and you need to check a fact, you have to open a browser and go looking for information. What if you had software that anticipated your needs and fetched the information before you knew you wanted it?

I don't expect to see mind-reading software anytime soon, but a Windows tool called blinkx, from a startup of the same name, can sometimes do a good imitation. Blinkx, available as a free download from www.blinkx.com, has the feel of a not-quite-finished product with interesting potential.

When you install blinkx, it creates a little toolbar that appears in the blue title space at the top of a Microsoft Word or Internet Explorer window. (A test version works with Netscape-based browsers, including Mozilla Firefox.) When you read a Web page, work with a Word document, or compose a message in Outlook, blinkx scans the Web and your hard drive for relevant information. As it finds results, the program lights up icons representing e-mail messages and other local files, news sources, Web pages, Web logs, videos, and products for purchase. Click on an icon, and a list of links with the pertinent information drops down. The search is continual, so as the subject matter of the document changes, so do the search results. Blinkx doesn't drown you with results, providing at most the equivalent of the first page of a typical Google search.

THE APPROACH WORKS BETTER when you're writing or editing than when browsing. Search results come in fairly slowly, even with a fast broadband connection: I found I was finished with a Web page before blinkx had turned up anything interesting. The software comes into its own when you are working with a long, complex document. In this case, you're more likely to want to search for related information, and blinkx will have more time to do its job. For example, when I was writing a recent story on open-source software licensing, blinkx came up with useful Web and news links that changed paragraph by paragraph.

Blinkx retrieves news faster than it does general search results. While it did occasionally turn up a mysterious item—such as a *Los Angeles Times* story on Michael Phelps's Olympic medals while I was reading a report on Cisco



Systems' acquisition strategy—most offerings were on target. The general Web and blog search was less satisfying, in part because the company is still in the process of building its Web index. The only source of video as of now is the BBC, which has undertaken the massive job of putting its archives of video online, indexed to facilitate searching. Eventually, blinkx hopes to expand search to other types of images. The purchases icon mainly produced links to related books, but that also likely to be broadened: Partnership with vendors are an important part of blinkx's somewhat sketchy business plan.

Blinkx scans your work and fetches links to relevant data

Local search was disappointing. Even after blinkx finished indexing my computer, it didn't always turn up all the applicable files. When I'm writing an e-mail to someone, I would expect it to find all e-mails on to or from that person, but I always got an incomplete list. Oddly, blinkx's conventional keyword-search tool did just fine turning up the local files.

Someday the sort of thing that blinkx is trying to accomplish should get a lot easier. The World Wide Web Consortium's Semantic Web project is redesigning the Web to give search tools the ability to read and understand sites' descriptions of themselves. But such enhanced information finding is years off, and Microsoft has just suspended plans to put such a feature in the next version of Windows. In the meantime, blinkx, imperfect as it is, points at a way to turn search results into information at your fingertips. ■

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BY ROBERT KUTTNER

The Latest Bush Plan—Consumption Taxes

Looking beyond the convention rhetoric, what economic program could we actually expect from a second Bush term? Further tax cuts would certainly be a top priority despite looming deficits of unsustainable scale. And unlike the *mélange* of tax cuts that marked President Bush's first term, these new cuts would all point in one direction—a move to consumption

taxes, to shift the burden of taxation off wealth and onto work.

Conservative antitax groups, such as Stephen Moore's Club for Growth and Grover Norquist's Americans for Tax Reform, are abuzz with the prospects of either a flat tax, a national sales or value-added tax (VAT) to replace all income taxes, an explicit consumption tax, or massive shelters for savings that would turn the income tax into a *de facto* tax on consumption only. The Treasury has its technical staff researching possibilities, and President George W. Bush said on Aug. 10: "I'm not exactly sure how big the national sales tax is going to have to be, but it's the kind of interesting idea that we ought to explore seriously."

WE CAN ALSO READ THE TEA LEAVES for a second term by reviewing several Bush tax proposals from his first term that did not make it into law. In its 2004 budget the White House proposed to exempt all dividends and most capital gains from taxation by crediting taxes that the relevant corporation had already paid. In a compromise, Congress cut rates on both dividends and capital gains, to 15%. The original Bush plan would have cost the Treasury \$396 billion in lost revenue over 10 years, according to the congressional Joint Committee on Taxation.

Another deferred Administration proposal would allow people to put large sums into savings accounts whose investment income would then be tax-free. Over time, this would shelter most investment income from taxation, leaving taxes mainly on wage-and-salary income. The Bush medical savings-account plan, allowing far larger tax-deductible accounts to pay for insurance premiums and medical expenses, is another variant on the same theme—as is the effort to kill the estate tax, the only explicit tax on accumulated large wealth.

All of these proposals will be back, and all have three things in common. First, they benefit mainly wealthy people with substantial discretionary income to save. As such, they would end what's left of mild progressivity in the tax system. Second, they would further increase the already alarming federal deficit. And perhaps most important, despite the "supply-side" rationale, there's no evidence that any of them would actually promote savings, investment, or growth.

Recent statistics suggest that the Bush supply-side medicine to date has been a notable failure as an economic tonic. The Census reported on Aug. 26 that, for the third straight year, median income fell in 2003. In inflation-adjusted terms, the median household lost \$1,535 in annual income between 2000 and 2003, according to the Economic Policy Institute's analysis of the Census data. By contrast over 10 years, the median household will realize only about \$620 a year from the Bush tax cuts. So the Bush economic program was a losing deal for the typical American family.

Nor has the Administration tax program been good for job savings, or domestic investment. The economy has one million

Bush's tax medicine hasn't worked so far, but get set for more

fewer payroll jobs than it did when the recovery started. According to a study by Mark Zandi, chief economist at Economy.com, only 0.1% of the 2001-03 growth can be credited to the tax cuts. Some 0.4% of the growth reflects increased military spending. Low interest rates get most of the credit for stimulating growth.

Practical failure has never stopped the supply siders. This time, however, there are two complications. First, like kids in

candy store, supply siders are uncertain which consumption tax to choose, and each variant raises concern. A VAT or national sales tax would strike some voters as just another new tax. As Robert McIntyre of Citizens for Tax Justice observes, getting all current federal revenue from a retail sales tax would require a rate of over 50%. And second, with many conservatives worried about the deficits, Congress might insist that any new tax be a net revenue-raiser, not a net tax cut supply siders want.

Of course, after November, these intoxicating supply-side choices might all be mercifully moot. ■

Robert Kuttner is co-editor of *The American Prospect* and author of *Everything for Sale*.



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Empowering Innovation

BY JAMES C. COOPER & KATHLEEN MADIGAN

An Economy with Two Engines Firing

Consumers and businesses are working in tandem to bolster growth

U.S. ECONOMY

As the U.S. women's relay mishap at the Summer Olympics showed, teamwork is the crucial ingredient to getting the job done. That's why the latest news from the economy's most important tandem, consumers and businesses, is so important to the outlook. Recent reports from the nation's households, manufacturers,

and chief executives all indicate the economy has crossed over its spring soft patch. Already, signs for economic growth in July and August are encouraging, even as the boosts from tax cuts and cheap financing disappear.

For consumers, the last few months have been a roller-coaster ride. Record gas prices and weak job growth took their toll on spring consumer spending and August confidence. But now, gas prices have come down sharply from their May highs, and consumers have returned to the shopping malls and car dealerships. Household purchases began the third quarter by posting a big increase, although future shopping gains will depend largely on the pace of job and income growth.

Businesses, meanwhile, have raced out of the starting blocks and become more forceful players in this recovery. Optimism among CEOs is rising. Manufacturers reported that business activity in August continued to move ahead briskly. And the outlook for profits, while not as heady as in 2003's second half, remains solid.

At the same time, the stock market has risen from its summer lows, and inflation fears, which pushed up bond yields in the spring, proved unfounded. In July prices for consumer goods and services were flat. That suggests the Federal Reserve can take its time raising short-term interest rates, another plus for the outlook. But most important, by working in concert, businesses and consumers assure that growth in the second half will be stronger than it was in the first two quarters.

THE IN-SYNC MOMENTUM of consumers and businesses can be seen in the latest revisions to gross domestic product. Real GDP growth was refigured down to an annual rate of 2.8%, from 3%, mainly reflecting a sharp deterioration in the foreign trade deficit as slower global growth held back exports. But real consumer spending and business investment on new equipment were revised higher. Also, businesses are finally restocking inventories at a pace that is adding to economic growth. As a result, domestic demand grew at a 4% annual pace last quarter, up from the 3% rate previously reported.

The growth in demand continued into July. Real consumer spending increased by 0.8% from June, while

shipments of capital goods were well above their second-quarter average. In addition, inventories of durable goods rose 0.8% for the third month in a row.

Without this surge in inventories, delivery and shortage problems could have threatened to curtail the factory rebound. Instead, the August readings on the factory sector show that activity, while a bit slower than

in July, was still growing at a healthy clip. The Institute for Supply Management's manufacturing index slipped to 59%, from 62% in July. A drop in production was mostly responsible for the slowdown. Still, as the ISM noted, "both new orders and production remain at high levels."

The ISM said that the

CEOs ARE FEELING UPBEAT ABOUT GROWTH



August reading, if maintained for a year, is historically consistent with 5.9% economic growth. But so far this year, the index is averaging an even higher 61.9%.

Clearly, businesses are feeling better about the economic outlook, an optimism that shows up in the September survey by the Business Roundtable, an association of CEOs of large U.S. corporations. The Roundtable's CEO economic outlook index rose to 101.7, the highest reading in the survey's two-year history (chart). The report said executives expect "further increases in hiring plans, gains in capital spending, and a robust level of expected sales" over the next six months.

ONE REASON FOR THE BETTER MOOD in the corner office is that corporate coffers are awash with cash. Corporate America has not loosened its grip on labor costs by much, and so the outlook for profit growth is not as dire as this year's performance in the stock market suggests. In the second quarter, the demand slowdown cut into operating profits—earnings adjusted for depreciation and inventory valuations. The Commerce Dept.'s tally of earnings edged up by just 0.1% from the

first quarter. But compared with a year ago, profits were up a still robust 18.4%.

To be sure, yearly growth is slowing. Last quarter's pace was down from a 27.8% jump in the first quarter. But companies are still managing their costs quite well, and that is helping profit margins. The margin earned for each unit of real GDP produced by nonfinancial corporations rose to 11% in the second quarter, the highest percentage in five years.

Margins might slip in the second half, as the effects of volatile oil prices work through the data and productivity gains slow. But the higher level of margins compared with one or two years ago means profits should get a double boost in the second half: The pickup in demand will bolster revenues, while high margins mean more of that cash will fall straight to the bottom line.

WHAT REMAINS TO BE SEEN is if the more buoyant business sentiment translates to greater hiring in the second half. Indeed, the key area where the baton handoff between businesses and consumers might falter is job growth, should second-half hiring continue its second-quarter malaise rather than return to its first-quarter muscle.

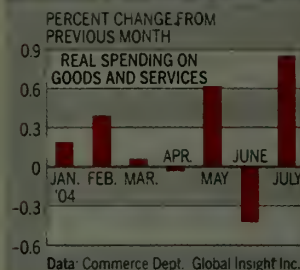
That fear weighed on consumers in August. The Conference Board said its confidence index last month fell a large 7.5 points to 98.2 from 105.7 in July. Consumers' assessments of the present economic situation plus their expectations both dropped sharply.

The board said "the slowdown in job growth has

curbed consumer confidence," noting that the percentage of respondents expecting fewer jobs in the next six months rose to 15.4% from 13.5% in July. Worries about energy prices, along with little progress toward stability in Iraq, probably also made householders wary.

The August confidence reading came off a two-year high posted in July, and it was in that month that consumers posted their largest spending gain of the year (chart). Purchases increased by 0.8% from June, when they had fallen 0.4%, after adjusting for prices. Motor-vehicle sales led the advance, but nondurable goods and services also posted increases. If the July

CONSUMERS BOUNCE BACK IN JULY



jump is followed by even modest gains in August and September purchases, then real consumer spending could grow at a 4% annual rate this quarter, much faster than its 2.9% gain over the first half.

With consumers spending at that pace, and teamed up with continued double-digit growth in business outlays, overall demand will remain strong. That will keep output growing and assure the solid gains in jobs and incomes necessary to keep the economy moving smoothly and swiftly down the track. ■

SOUTH KOREA

Debt-Laden—And Facing Slower Exports

SOUTH KOREA'S economy, already hobbled by enormous household debt, faces more hurdles in the coming year. Exports, which have been carrying the economy recently, are slowing, putting the Bank of Korea in a dilemma: It is cutting interest rates, already at a record low, even as energy-driven inflation is accelerating.

Based on growth from a year ago, the 5.5% advance in second-quarter real gross domestic product, powered by a 27.2% gain in exports, seems respectable. But looking closer, both exports and the overall economy slowed from the first quarter, and consumer spending continued to contract.

Household

spending is unlikely to pick up strongly. After a borrowing spree, some 10% of Koreans age 15 and older are at least three months delinquent in their debt repayments. Government efforts to help consumers have shown little impact, and inflation, which hit 4.4% in July, is sapping purchasing power. Also, labor markets look weaker as unemployment climbs, especially

among less educated, lower-income workers, on whom the repayment burden is heaviest.

Now, exports are slowing. Korea is highly dependent on China's markets, which are cooling as Beijing tries to curb growth. And higher oil prices are sapping global growth

generally. In addition, export gains aren't feeding back to domestic demand or jobs as strongly as they once did, because Korean investment is increasingly flowing to China. After Hong Kong, Korea is now the mainland's second-largest investor.

Amid fears of new weakness, the BOK unexpectedly reduced its policy rate to 3.5%, from 3.75%, on Aug. 12. Since then, industrial production was reported to have declined in July for the second month in a row, with losses in two crucial export sectors: semiconductors and autos. Chances for yet another rate cut are rising.

So are worries about stagflation. Real interest rates, adjusted for inflation, are already negative, and higher inflation is likely to fuel wages, as unions demand offsets. Low rates will help consumers by supporting housing, but they also could fuel speculative investment in real estate and generate a housing bubble. ■

OUTPUT LEVELS OFF



Andy Xie, Morgan Stanley Economist

Popping the China question:

Will the bubble burst or gently deflate?

Financial markets are worried about a hard landing in China. Should they be?

China's government has tightened credit policy and restricted land supply to cool investment — this is the right policy. Speculative capital poured into China for two years as the Fed cut interest rates to 1%. Ample liquidity triggered an investment boom that exacerbated inflation. The resulting negative real interest rate amplified investment demand and caused a speculative bubble. China may have invested US\$200 billion more than it should; fixed investment may be 20% above trend. This must be brought below trend for a period to absorb the excess.

It is still too early to say whether China will have a soft or hard landing. The measured pace at which the Fed is raising interest rates increases the chances of a soft landing, while the uncontrollable nature of unwinding a speculative property bubble makes a hard landing more likely. In either scenario, the global impact on commodity prices and equipment demand is roughly similar.



Longer term, whether the landing is hard or soft does not make a significant difference. In a soft landing, the economy decelerates to trend after a period of above-trend growth. In a hard landing, the economy decelerates below trend for a period. A hard landing can actually be a good thing, as excess capacity is flushed out quickly, leading to faster recovery in demand and profit. A soft landing brings less pain short term but may retain excess capacity, causing demand to recover slowly and profit margins to stay low for longer.

A slowdown in China affects commodity and equipment industries most. Commodity prices have risen sharply in the past two years on surging domestic demand, and the global equipment sector is booming. Imports to China have doubled since 2001, mainly on demand for commodities and equipment,

so economies specializing in these would be most affected as Chinese demand cools.



Global consumers would benefit from a China slowdown. Negative real interest rates helped Chinese businesses pay for commodities, causing prices to rise. Higher prices trimmed consumer purchasing power around the world. As China's economy softens and commodity prices revert to trend, consumer purchasing power everywhere should improve.

A government-controlled financial system amplifies China's business cycle. The financial sector does not price risk properly, causing the economy to overshoot in both directions. As the financial system is reformed and becomes more market-based, China's economy will become less volatile.

Cycles matter. From a low base, the industrialization of China has had a long history of rapid growth. However, economic cycles will always come and go, and businesses must plan accordingly. The right strategy is to accumulate cash at cycle peaks and invest at cycle bottoms. China will become a rich country. You can enjoy its wealth, too, if you are still in business.

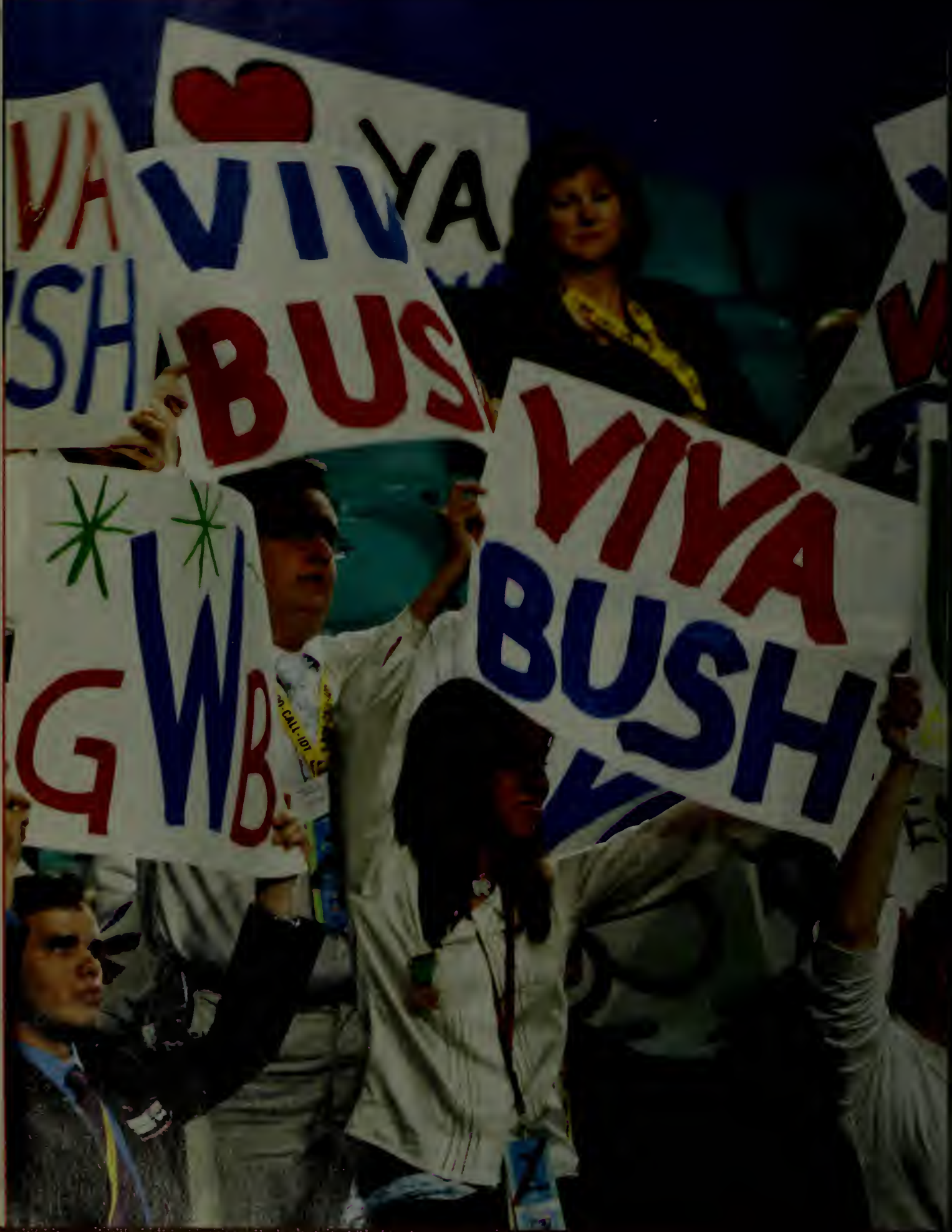
Andy Xie
Economist

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News Analysis & Commentary





ELECTION 2004

THE INVISIBLE CAMPAIGN

Bush vs. Kerry: For both campaigns, it's all about the turnout

AS POLITICAL CHOREOGRAPHY goes, it would be difficult to top the Aug. 30-Sept. 2 Republican National Convention in New York City. Preceded by a bevy of leading party moderates—from former Gotham Mayor Rudolph W. Giuliani and New York Governor George Pataki to California phenom Arnold Schwarzenegger and Senator John McCain of Arizona—President George W. Bush was poised to cap a star-studded spectacle in Madison Square Garden by returning to the compassionate themes that swept him to office in 2000.

Certainly, Bush's footlight parade got off to a smooth start, since talk of *Kulturkampf* was as scarce as Veterans for Kerry banners in the hall. In remarks prepared for delivery on Sept. 2, Bush planned a main-

stream address aimed at reminding Americans of the economic and national-security challenges that the nation has faced since the September 11 attacks and stressing the role that tax cuts played in reviving a wounded economy. In a second term, the President vowed to expand the middle class, promising private investment accounts within Social Security, a streamlined tax code, a boost in student test scores, and broader access to health insurance—a bundle of reforms that underpin his new Ownership Society.

Is Bush suppressing his inner conservative in order to campaign solely in the middle of the road? Yes and no. While pasteurized pageants such as the New York convention are important, there are too few uncommitted voters left—only one in 13 say they could still be swayed—to assure victory. That's one reason why he and Democratic rival John Kerry have been deadlocked all summer.

To win, the President has rolled the dice on a bold plan to boost the turnout

IN NEW YORK
A message for the mainstream

JEFF HAYNES/AFP/GETTY IMAGES

of Republican-leaning voters by adding millions of supporters to the rolls—especially evangelical Christians, small business owners, elderly investors, and military families.

In essence, Bush's fate now rests on an invisible campaign: a battle fought below the radar by partisans poring over computerized census data and by legions of volunteers trolling shopping malls and knocking on doors. But stealthy as the plan may be, it still poses problems for White House *über-pol* Karl Rove, the field general behind the mobilization drive.

FED ON FAITH ALONE?

WITH A LARGER potential voter pool and an army of grassroots organizers supplied by labor unions, Democrats are past masters at the turnout game. This year, they're bankrolled by well-heeled 527 committees—new groups that can accept soft money—so their ground blitz could negate Republican efforts.

Moreover, while Bush has done a far better job than his father when it comes to tending to the Right, he is not the iconic figure that Ronald Reagan was. So his decision to tone down the red-meat rhetoric and campaign as a pragmatist complicates any base-activation strategy. That means the President will have to energize many of the party faithful on faith alone.

One thing Bush has going for him is the intensity factor. Polls find that many GOP voters—influenced by the constant skewering of Kerry as a flip-flopping Massachusetts liberal in ads and speeches—are more ardent in their backing for Bush than Democrats are in support of their champion. Still, despite the fact that 92% of Republicans are lined up behind Bush, the conservative base is not monolithic. The President has a complex task ahead as he crafts differing appeals to turn out partisans in record numbers. Among the challenges: **It's the Deficit, Stupid.** Economic con-



servatives love tax cuts but are upset by an estimated \$425 billion deficit and want Bush to draw the line on pork-barrel spending. But he has been reluctant to butt heads with GOP Hill barons. "Bush needs to get the budget under control," says one outside adviser.

This isn't just an abstract problem, because many mainstream Republicans do not buy the White House line that deficits have no link to economic growth. "If you are an economic conservative from a Midwestern battleground, you don't have anything to talk about on the fiscal side," says one GOP consultant. "We're being asked to defend a huge deficit that we cannot defend."

The Social Divide. Social conservatives give Bush credit for pushing right-to-life

judges, a Constitutional ban on gay marriage, and a partial-birth abortion ban along with restrictions on stem-cell research. But on the whole, they think he has been more compassionate than conservative. "A lot of people at the grassroots aren't motivated," says conservative leader Paul M. Weyrich. What's the beef? Activists want Bush and his team to stump aggressively for the gay-marriage amendment and to take the Culture Wars to Hollywood and other purveyors of popular culture. But Bush Co. "are allergic to anything that spells controversy," Weyrich fumes.

To spur turnout by the 4 million-plus evangelicals who sat out the last election, the Bush campaign is relying on fundamentalist Christian leaders to quiet

HOW TO WIN THE TURNOUT WAR

Republicans and Democrats are waging an unprecedented ground war as they scour the country for

VOTER MAGNETS

» Energizing base voters will be crucial. The GOP is using churches to get up to 4 million more evangelicals to the polls, citing hot-button issues like gay marriage. The Dems have massive plans to up black and Hispanic turnout, hammering President Bush on scarce jobs, health-care costs, and sub-par schools.

FACE-TO-FACE CAMPAIGNING

» Both parties are deploying armies of workers to repeatedly talk to voters. This strategy, which relies on multiple visits, follow-up calls, and e-mailed pitches, makes Campaign '04 a real front-porch affair. The challenge for party brigades: Being persuasive without resorting to Willy Loman tactics.

ELECTION INSURANCE

» Efforts to boost base voting are fine. But in a tight race, the GOP and Dems also need to enlist as many new voters as possible. In battlegrounds such as Florida, Democrats are ahead in the sign-up sweepstakes. But new Republicans have a higher propensity to vote than their Democratic counterparts.

INTENSITY FACTOR Bush's supporters are more ardent than Kerry's, polls show

spread the gospel of St. George with personal visits to church groups, direct-mail flyers, Web appeals, and "nonpartisan" voter guides. One message that will be passed sub rosa will stress a reelected Bush's ability to name a pro-life majority to the Supreme Court.

The Live-and-Let-Live Set.

Although most Republicans these days are conservative on social and economic issues, a band of culturally tolerant moderates can't be ignored, especially in swing states such as Pennsylvania, New Hampshire, and Ohio (page 36). Their complaint is the opposite of that voiced by social conservatives. The mod squad fears the Administration

is in thrall to the Religious Right on issues ranging from scientific research to gay rights to gun control—a course that could mark the party for slow irrelevance in the Northeast.

"It's smart to use McCain, Schwarzenegger, and Pataki in New York, because Republicans need a moderate face," says one GOP strategist. "Rove's turn-out-the-base strategy won't be enough. You need moderates to win."

Of course, simply identifying the issues and personalities that will rev up the various elements of the party is just a start. Getting them to storm the polls in record numbers poses a further challenge. So despite some misgivings from the ranks, Rove is barreling ahead with a base-mobilization operation that, he is

convinced, will vault the President to a second term.

But Rove doesn't have the playing field to himself, since Democrats are launching a parallel turnout drive that's every bit as ambitious. That's where the invisible campaign comes into play. It's a behind-the-scenes struggle that's being waged, precinct by precinct, by both campaigns and political parties, business groups, unions, environmental organizations, and the new 527s. Political experts say that as a result of the two parties' exertions, turnout, which was only 51% in 2000, could hit 1992's 55%, and maybe even the 61% tally of 1968.

Despite concerns about the role of 527s, an election that centers on neighbor-to-neighbor buttonholing is a healthy development after years of voter malaise. It also is a frank admission of the limited role that TV advertising plays in a campaign where Red Zone and Blue Zone warriors have fought to a standoff. Through August, Bush has spent \$120 million and Kerry \$80 million barraging swing-state voters with TV appeals, with an additional \$60 million spent by outside groups, mostly on Kerry's behalf. The result has been rising negatives for both combatants, more confusion about each man's governing agenda, and a statistical deadlock in the horse-race polls.

"Paid media won't do it for you, so whoever does the better job of getting their supporters to the polls will win," says Ralph Reed, who, as Bush's Southeast regional chairman, helps oversee turnout in the crucial battleground of Florida (page 34). "It's that simple."

Grassroots mobilization is not new, of course. What's novel this year is the intensity of the effort and the megabucks being spent. And thanks to the 2002 campaign finance reform law, a large chunk of this year's turnout effort is privately financed by such liberal 527s as America Coming Together (ACT). Campaign laws bar political parties and candidates from raising unlimited soft dollars. But ACT operates under no such restrictions and plans to spend \$120 million on voter recruitment in 15 swing states.

At least 50 other independent groups also have turnout projects, ranging from the labor unions to Business-Industry Political Action Committee (BIPAC) to PunkVoter, which aims to register punk-rockers. "The old party bosses would weep to have that kind of money" to

spread around their wards, marvels John C. Green, a political scientist at the University of Akron. Adds Donna Brazile, who managed Al Gore's 2000 race: "I've never seen anything like it."

Unlike many past campaigns' slapdash operations, which gave out "walking-around money" with little accountability, this year's methods are more sophisticated—and measurable. Bush campaign headquarters, for example, has assigned every key state a voter-registration goal, a block-party goal, and a voter turnout target. In precincts that went 60% for Bush in 2000, says Reed, the aim is to boost that number to 80%.

Compared with every other form of voter outreach, spending on turnout is money well spent, according to studies by David C. King of Harvard University. He finds that leaving literature on voters'



We had gotten away from using person-to-person contact. Talking about issues with someone from your church or neighborhood really makes a difference."

—Blaise Hazelwood
GOP 72-Hour Program Director

doorknobs boosts the probability of voting by just 1.3%, at a cost of \$29 per vote. Phone calls aren't much better: They increase the likelihood of voting by 3.5%, at a cost of \$24. But face-to-face contact increases the chances that a person will vote by 18%, at a cost of \$28. "In an expensive media market, that's an absolute bargain," says King. "People are waiting to be asked to vote by a person who seems similar to them."

SWING-STATE STAKES

IN BATTLEGROUNDS where one candidate has pulled ahead, get-out-the-vote programs are do-or-die. Take Pennsylvania, a swing state that Al Gore won by four percentage points in 2000 but that Bush hopes to recapture this year. An Aug. 2-15 Keystone Poll, a nonpartisan statewide poll conducted by Franklin & Marshall College, showed that 11% of Bush's 2000 voters say they are defecting to Kerry, while just 5% of Gore's voters plan to switch to Bush. The only way Bush can do better this time is

strategies:

VERING THE GOODS

• GOP's 72-Hour Program is a nationwide plan to deploy 1 million volunteers in the closing three weeks of the campaign. The goal: to get turnout up to 80% in key Republican precincts. Dems are going into the transportation business, offering free rides to ferry youths, minorities, and single moms to the polls on Nov. 2.

by turning out more of his base—especially anti-abortion Catholics.

Indeed, Bush's strategy across the country is to edge Kerry by turning out more committed conservatives in counties where he is already strong. He is targeting Christian evangelicals who didn't vote in 2000, conservative Catholics who respond to a family-values message, and small-businessfolk who like the President's anti-tort lawyer pitch (page

49). He has charged "people of faith" team leaders with the task of identifying churches whose congregants are likely supporters. His ground troops are asking churchgoers, Rotary Club officials, and Knights of Columbus leaders to send in membership directories, which are then compared with voter registration rolls. Anyone who is not registered can expect to get a call from a volunteer. And like Kerry, Bush has his sights

trained on some 7 million non-Cuban Hispanics and 2.7 million military personnel and their families.

While both candidates' goals are equally ambitious, their tactics differ. The GOP model is the 2000 Bush campaign's 72-Hour Task Force, designed by Rove and current campaign manager Ken Mehlman. The project, which took months to plan but was unleashed in the final three days of the campaign, com-

ELECTION 2004

Squeezing Out Every Last Florida Vote

Incredible as it seems, the 2004 Presidential race could again come down to a handful of votes in Florida. An Aug. 20-22 Gallup Poll showed a statistical dead heat, with President Bush at 48%, Democrat John Kerry at 46%, and Sunshine Spoiler Ralph Nader, who's on the ballot on the Reform Party line, tallying 2%.

With Florida's 27 electoral votes up for grabs, both sides are pulling out all the stops. "Turnout is the election story in Florida," says University of South Florida political scientist Susan MacManus. "The parties are using every known interpersonal skill and technological device."

The Bush campaign is courting voters in traditional GOP strongholds: South Florida's Cuban-American enclaves and the Panhandle, with its rich trove of fundamentalist Christians and veterans. By contrast, Kerry's forces, which include the liberal turnout group America Coming Together (ACT) and others, are signing up voters among the state's burgeoning minority populations—African Americans, Haitians, Jamaicans, and Puerto Ricans.

So who's grinding it out best on the ground? According to the Florida State Dept., the GOP has added nearly 275,000 new voters since 2000—12,000 more than the 263,000 the Dems have picked up. But in total voters, the GOP still trails.

The two turnout machines are braced for a massive push in the campaign's final weeks. The heart of the fight lies in the Orlando-to-

Tampa corridor linked by Interstate 4. Bush won GOP-leaning Tampa by two percentage points in 2000, while Gore took nearby St. Petersburg by the same two-point margin. And Orlando is fickle: Gore grabbed more votes in the city in 2000, but Governor Jeb Bush beat his Democratic opponent there in 2002.

The ground war can be tough. Every afternoon at 2:30, four vans bearing canvassers, each of whom is paid between \$8 and \$10 per hour and wears a bright red-and-yellow T-shirt, sets out from ACT's Tampa headquarters. Using past voting records, census data, and polling numbers, they target minorities, young adults, and the working poor. San Franciscan Elizabeth Mauldin, 23, is typical: She toils for ACT six hours a day, six days a week in search of undecideds willing to talk about health care and jobs. When she knocks on a door, a specially programmed PalmPilot tells her if the occupant identifies with a party or has voted in the past. By law, she can't advocate for Kerry or against Bush. Instead, she decries how the new Bush-backed Medicare drug benefit "has brought drug companies a windfall."

Things are just as tough for real estate agent Kathy Prichard and recent college grad Ricardo Rodriguez, who walked



DOOR TO DOOR An ACT canvasser calls up voter data

Precinct 562, just north of Clearwater, for Bush on Aug. 21 in 95-degree heat. It took an hour to hit eight houses. They chatted up one Bush supporter and one swing voter—and one man shut the door in their faces. But they hit pay dirt when small-business owner Doug Weaver said he was pro-life, pro-Bush, and might even be willing to do some canvassing.

Florida is so competitive that some vote hunters are starting to bump into each other. One day in August, a Bush phone-bank caller in Tampa dialed a woman who was working the phones for Kerry. Oops. Despite such crossups, the voter mobilization campaign in Florida—and across the U.S.—will grow more intense as Nov. 2 draws near. Both sides know victory depends on it.

—By Paula Dwyer in Washington, Lorraine Woellert in Tampa, and Alexandra Starr in Fort Lauderdale

FLORIDA'S TALLY

	DEMOCRATS	GOP
Registered Voters (As of Aug. 2)	4.1 MILLION	3.7 MILLION
Increase Since 2000	+6.9%	+8%

Data: Florida State Dept. of Statistics

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ELECTION 2004

What's Scaring Bush In These Swing States

Even before the balloons and confetti rained down on the GOP faithful in Madison Square Garden, the Bush campaign was claiming victory, after a fashion. With several polls showing that the President had erased Democrat John Kerry's small lead, the President's supporters declared that the dynamic in the race now favored George W., not a rival who had spent much of August in a defensive crouch. "We're where I thought we'd be on the day after Labor Day," says chief Bush strategist Matthew Dowd.

Yet as Dowd knows, it's not the popular vote that counts, since state-by-state Electoral College numbers determine the winner. And big mo' or no, Bush still faces a tough job of reaching the magic number of 270 electoral votes. Indeed, efforts to piece together an electoral majority have been complicated by a series of local political obstacles in key battlegrounds. The challenges range from wobbly state economies to demographic shifts and not-in-my-backyard environmental fights.

Just look at Nevada, which Bush won by 3.5 percentage points in 2000. A recent influx of Latinos and others from California has transformed a traditionally Republican state into a toss-up. But the factor that could tip the balance is the wildly unpopular federal nuclear waste dump at Yucca Mountain, 100 miles northwest of Las Vegas. In 2000, Bush capitalized on local ire by declaring that, as

President, he wouldn't O.K. dumping to any site "unless it's been deemed scientifically safe." Two years later, Bush signed a bill to designate Yucca as a nuclear waste repository, setting off vociferous local protests. And now Kerry insists he will never allow the feds to bury waste in the Silver State.

Demographic shifts also have changed the political landscape in Florida. New residents from the North and non-Cuban immigrants from the Caribbean are quickly tilting the state toward the Democrats. Since 2000, there's been a 30% increase in the Hispanic voting-age population—nearly all of it non-Cuban, notes Ed Kilgore, policy director of the centrist Democratic Leadership Council. To overcome the Dems' gains, Republicans have redoubled efforts to register conservative

Christians and pro-Bush Cuban Americans.

While newcomers are cause for Republican concern in Nevada and Florida, economic woes have created tighter-than-expected races in Ohio and North Carolina. In the Buckeye State, Bush is on the defensive because of the loss of 170,000 manufacturing jobs during his Presidency. "Ohio is an economically driven state frustrated with the pace of the recovery," says conservative analyst Frank I. Luntz. To overcome econo-angst, the Bush campaign is stressing "values issues" that favor the GOP, particularly Bush's opposition to gay marriage and abortion.

That's also how the President is hoping to hold North Carolina, a state he carried in 2000 by 13 percentage points but which is much closer this year, continuing decline of the textile industry, has shed thousands of jobs, is mostly to But the Vice-Presidential candidacy of Jo

WHERE BUSH IS VULNERABLE The Pres

WON BY BUSH IN 2000

FLORIDA



New voters from the North and the Caribbean have moved in, helping Democrats. The Bush campaign is stepping up efforts to

*Electoral votes

NEVADA



The feds are develop a nuclear waste sit Yucca Mountain af Bush suggested in that he would stop dump. To neutraliz fallout, Bush aides that Democrat Ker

on both sides of the issue.

bined last-minute phone calls, leafletting, and rides to the polls. For the 2002 midterm contests, the party assigned 72-Hour directors to all 50 states. And the program produced some surprising winners. One was Saxby Chambliss, now a Georgia senator thanks in large part to turnout efforts led by then-Georgia Republican Party Chairman Reed.

FACE TO FACE

A ONETIME CHIEF political operative for the Christian Coalition, Reed is credited with helping to harness the Religious Right's emerging might. He recruited 3,000 volunteers and 500 paid workers to knock on some 150,000 doors in Republican-leaning Georgia counties. While midterms normally draw about one-third of the voting-age

population, Reed boosted turnout to 60% in GOP precincts, sweeping Democratic incumbents out of the governor's office, the U.S. Senate, and the state legislature.

The lesson for the GOP was that face-to-face appeals work better than phone banks, leafletting, direct mail, and even TV. "We had gotten away from using person-to-person contact," says Blaise Hazelwood, political director of this year's 72-Hour Program. "Talking about issues with someone from your church or neighborhood really makes a difference."

The GOP is getting lots of help from business groups. BIPAC is coordinating

turnout efforts among dozens of member trade associations and hopes to reach 20 million employees before Nov 2. "In an election that's going to be de

termined by turnout," says BIPAC CEO Gregory S Casey, "this seems the smart way to go."

The 10,000-strong American International Automobile Dealers Assn. has its "Drive the Vote" campaign. Voter guides, while officially neutral, stress Bush's call for cuts in tariffs on imported cars and

trucks and suggest that Kerry would push to unionize workers at foreign auto plants. "We want to make sure [dealers employees] understand this election i

Kerry has taken a leaf from labor's turnout program



PRAIRIE HEAT Nevadans are angry over Yucca Mountain

unabashed in their upbeat assessment of local prospects. Commerce Secretary Donald L. Evans, for instance, argues that tech and service jobs have more than compensated for the textile troubles. "North Carolina is a model example of our economy in America," Evans insists.

The values debate may work in Bush's favor in Ohio and North Carolina, but it could backfire in Pennsylvania. In the GOP-leaning Philadelphia suburbs, a large bloc of culturally liberal swing voters are turned off by the party's social conservatism. A vast majority of suburban women

favor gun control and abortion rights, and many consider a constitutional ban on gay marriage unwise. An Aug. 2-15 Keystone Poll, a nonpartisan statewide poll conducted by Franklin & Marshall College, found that

independents and moderates in the state favored Kerry over Bush by a 2-to-1 margin. The concerns about social issues shaved Bush's lead in economically conservative suburban Philly to just three percentage points—trouble in an area where Republicans outnumber Democrats 3 to 2. "Bush needs to be ahead by 8 to 10 percentage points there to carry the state," says Keystone Poll director G. Terry Madonna, a political scientist at Franklin & Marshall.

Even if the suburban swing voters are lost, the Republicans aim to compensate for any defections in southeastern Pennsylvania by wooing culturally conservative gun owners in the depressed southwestern section of the state. That'll be a challenge: The Keystone Poll shows Kerry ahead there, 54% to 35%.

In the end, the best way for Bush to win swing states is to bump up the national vote by two or three percentage points. A good convention is a start toward that goal. But Team Bush knows that it can't afford to ignore community concerns along the way. This year, as Dowd notes, "A few hundred votes in a few states can make a lot of difference."

—By Richard S. Dunham in New York

ds, son of a retired North Carolina mill
r, is hurting, too. An Aug. 23 Zogby poll
d Kerry and Edwards running one
stage point ahead in the state.
heless, top Bush lieutenants are

serious challenges over local issues in several battleground states:

NORTH CAROLINA



The export of textile jobs and the presence of local favorite

Edwards on the Democratic ticket has formed a GOP-leaning state into a competitive one. Republicans counter that Massachusetts liberal at the top of the doesn't share their Southern values.

OHIO



The manufacturing collapse in eastern Ohio has many blue-collar swing voters leaning toward Kerry. To stem the tide, among these socially conservative workers, Bush will focus on "values issues," such as opposition to gay marriage and abortion, that favor the GOP.

PENNSYLVANIA



Many independents and Republicans in the Philadelphia suburbs are disturbed by the GOP's conservative

social agenda. To compensate for the defections, the campaign is trying to woo culturally conservative Democrats in rural southwestern Pennsylvania.

WON BY GORE IN 2000

not without consequences," says Ed Parru, an AIADA spokesman. And the National Federation of Independent Business is sending out election tip sheets that steer its 600,000-plus members to vote for Bush and other candidates the NFIB considers pro-enterprise.

Kerry's appeals are directed at a more diverse group. He's eyeing union members, minorities, single mothers, and young adults between 18 and 24. He's also aiming for the sliver of the electorate that is still undecided and for less ideological Republicans.

The pool of potential backers is certainly deeper, but the Democratic Party's bedrock of support—African Americans and other minority voters—historically have low turnout rates. So Kerry's challenge, much like Bush's, is to avoid alien-

ating his base while wooing middle-of-the-road suburbanites.

To keep the core motivated, Kerry is relying largely on ACT, which has opened 55 offices and hired 540 full-time organizers along with 1,300 paid canvassers. The model is Big Labor's turnout program, until 2002 led by AFL-CIO political director Steve Rosenthal. In his new role as ACT's executive director, Rosenthal has put together a national turnout effort that clearly has Republicans worried.

Rosenthal tested his ideas—early and frequent contact with potential voters to discuss issues, not necessarily to push a candidate—in the 2003 Philadelphia mayoral race. There, he registered 85,000 new voters, of whom 38,000, or 44%, cast ballots. While slightly lower than the 49%

overall turnout, the additional support was crucial: Democratic incumbent John F. Street turned around a faltering campaign to win by 78,000 votes.

Any way you slice it, Campaign 2004 looms as a fateful showdown between sharply divergent approaches to foreign policy and the economy. And for once, it doesn't look like the outcome is going to be determined by glossy TV spots that generate more heat than light. Instead, the election seems certain to be decided on front porches, in community centers, and in individual encounters all across the land—a struggle, to paraphrase George Bush, that can only be won "one heart, one soul at a time." ■

—By Paula Dwyer and Lee Walczak
in Washington and Lorraine Woellert
in Tampa

COMMENTARY

BY STAN CROCK

If You're Not With Us...

Would Bush cultivate multilateralism if reelected? Don't bet on it

RECENTLY, SOME FOREIGN diplomats have concluded that if he wins a second term, George W. Bush might hang up his Lone Ranger mask and turn in his silver bullet. After three years of clashing with international organizations on arms control, global treaties, and the charge into Iraq, he has at times seemed to soften the “with us or against us” rhetoric that sets teeth on edge in foreign capitals. After hanging tough in talks over North Korea's nuclear program, the Administration is now dangling inducements. In Iraq, the White House asked the U.N. to play a major role in crafting the new political process, and the U.S. has begun awarding contracts to companies from countries that opposed the war. It has all led to predictions of a kinder, gentler policy. “If Bush is reelected, his second term will have to be more realistic, more moderate,” says Dominique Moisi, a top adviser to the French Institute of International Relations.

Don't bet your *foie gras* on it. Administration insiders say that, despite any shifts on his national security team, the President is determined to take a proactive role in the war on global terror. That means he would keep up the pressure on rogue states—and on allies that aren't equally aggressive in fighting terrorism. Experts call the small shifts on Iraq and North Korea tactical, not a strategic U-turn. And if, as expected, Secretary of State Colin L. Powell steps down, his successor may lack both his stature and pragmatic bent.

Liberated from reelection concerns, Bush would be freer to be Bush—a plain-spoken leader who believes that September 11 thrust the U.S. into a new era where traditional concerns about sovereignty and international consensus gave way to the overriding need to strike America's enemies before they acquire lethal weapons. “You can't afford to let threats gather,” National Security Adviser Condoleezza Rice, who could succeed Powell, told *BusinessWeek* on Aug. 30 (page 40).

This worldview reflects the thinking of Defense Secretary Donald H. Rumsfeld. But it's likely to prevail even if Rummy decamps and is replaced by a moderate, such as Navy Secretary Gordon R. England. The policy drivers are Bush and Vice-President Dick Cheney, who would still be calling the shots. “I don't

NAJAF The hawkish views promoted by Rumsfeld & Co. would likely prevail



detect any questioning of the basics” on Bush's part, says one Republican foreign-policy mandarin. “It's unlikely a second term would be fundamentally different from the first.”

Ripples of Discontent

STILL, CERTAIN REALITIES may force at least some changes in a Bush Act II. No Administration can endure a setback such as the Iraq occupation—a costly affair that has left Iraqi radicals in charge of major cities—without consequences. At a minimum the mess has forced the Bushies to ask for more Allied help on issues ranging from rebuilding to a U.N. blessing for the new political structure. The massive cost of the war—some \$124 billion budgeted so far—is draining the Treasury and threatening GOP initiatives from tax cuts to Social Security reform. U.S. armed forces are stretched thin, limiting their ability to operate elsewhere. Finally, there are the suppressed ripples of discontent among traditional GOPers, who abhor nation-building.

One possible change: The neoconservatives determined to mold new democracies around the world could lose considerable clout. Former Defense Policy Board Chairman Richard N. Perle already has left his advisory post. Deputy Defense Secretary Paul D. Wolfowitz, a key architect of Iraq policy, could depart. So might Defense Under Secretary for Policy Douglas J. Feith; a staffer in his office is in hot water over an alleged leak to Israel.

What's more, even if Bush can start to extricate the U.S. from Iraq by 2006, the challenges for the President's assertive policy just get tougher. Iran and North Korea, the other members of Bush's Axis of Evil, aren't the hollow military targets Iraq was. "Options for military force are relatively limited" with those nations, says Arizona Senator Jon Kyl, a GOP national security specialist.

As the turmoil in Iraq shows, military force often isn't

stronger economic ties to the outside world than Iraq, as well as a more formidable military. That makes the likelihood of a U.S. strike against Iran's nuclear facilities low. So despite the risks that economic sanctions could backfire, some U.S. officials hope tough ones could slowly erode support for the unpopular Tehran theocracy.

Ambivalent Allies

THAT WOULD REQUIRE cooperation from European allies, who are willing to help—to a point. They postponed a trade pact with Iran and backed condemnation of Tehran by the International Atomic Energy Agency. But they're not ready to follow the U.S. in threatening to strangle the country economically unless Tehran disarms. "It's not an economy that's on its knees," notes Steven Everts, a researcher at the Center for European Reform in London. The Europeans might support targeted sanctions on the oil and gas industry and tourism. But Deputy Secretary of State Richard L. Armitage told *BusinessWeek* on Sept. 1 that the U.N. Security Council has little enthusiasm for sanctions. He wonders whether anything can stop Iran from becoming a nuclear power. "The dream of being a player on a large stage is in the breast of most Iranians," he says.

Things also look dicey on the Korean Peninsula. The U.S. plan to draw China and other regional powers into talks to pressure North Korea on nuclear arms has yielded few tangible results. And a U.S. offer of incentives to Pyongyang is falling flat.

Experts fear the threat of U.S. military action could bolster strongman Kim Jong Il's insistence on maintaining nuclear capability. "Dismantlement of [the] nuclear program would seriously undermine his power base," says Kim Sung Han of Seoul's Institute of Foreign Affairs & National Security. Bush will have to rely on China, which has kept Pyongyang afloat, to squeeze the regime. While China doesn't want a nuclear Korean Peninsula, it doesn't relish a wave of refugees, either. There's evidence, U.S. officials say, of increasing Chinese dismay with the North, so Beijing could come through.

Given the reality of a world of stateless threats and proliferating weapons, such messy

situations are inevitable. But the Bush crew's hot rhetoric—and the headlong rush into Iraq—haven't made resolving them any easier. For every Libya, which renounced its weapons program, there's an Iran or North Korea, dictatorships made more paranoid by the fear that someone really is after them.

Strengthening alliances and persuading adversaries that they don't have a bull's-eye on their back may be one way to emerge from this box. Even the President's admirers among Europe's nascent democracies suggest that he may want to lower the temperature. "Bush has to be more careful and tactful in what he says," says Istvan Szent-Ivanyi, a Hungarian member of the European Parliament.

The evidence so far, though, is that Bush will try to hang tough, even as he is forced to make some policy adjustments on the margins. That won't set many hearts aflutter in Paris, Berlin, Moscow, or Beijing. But it is a key to understanding where U.S. foreign policy would actually go—as opposed to where some would like it to go—should Bush win reelection. ■

HAWK REDUX

How a second Bush Administration could deal with three key hot spots

IRAN The Bushies will offer Tehran a stark choice: get rid of its nukes or be isolated. They hope to capitalize on European dismay over Iranian violations of an earlier deal designed to stop any diversion of nuclear knowhow to weapons making. But European capitals may not go as far and as fast as Washington wants in imposing sanctions.

NORTH KOREA The Administration wants to confront the budding nuclear power but is counting on Beijing to be the heavy. It has leverage as the beleaguered nation's major energy supplier. But pulling Pyongyang's plug could collapse the economy and send refugees flooding into China.

IRAQ The White House is banking on political evolution in Baghdad, combined with better-trained local forces, to rob the insurgents of their support. Provisional elections in January are supposed to lead to a constitution and more elections by the end of 2005. The hope is that will enable the U.S. to pull out gradually.

enough to achieve policy goals. The Bush team acknowledges that and insists that it values diplomacy. But the Iraq intervention has alienated many allies. A Harris Poll in June found approval for the Administration averaging just 7% in both Iraq coalition partners such as Britain and Italy and war foes France and Germany. "The second Bush Administration could well face much more serious problems than the first," says Geoffrey Kemp, a GOP foreign policy expert at the Washington-based Nixon Center.

With hostage-taking sapping the will of some Iraq coalition partners, the Administration's best hope is a gradual U.S. troop pullout that begins late next year. Growing support for a freely elected Iraqi government could weaken insurgents' arguments that the regime is an American puppet. "The military is trying to provide a secure environment," says Rice. "But it's the political struggle that matters."

The next major flash point looks to be Iran, which Washington charges is intent on pursuing a nuclear program. Iran has



Q&A

'YOU CAN'T AFFORD TO LET THREATS GATHER'

Condoleezza Rice on how Bush would address security issues in a second term

NATIONAL SECURITY ADVISER CONDOLEEZZA RICE is one of President Bush's most trusted aides. She started off tutoring him on foreign policy during the 2000 campaign, then emerged as a key behind-the-scenes player as September 11 shifted the national-security focus from constraining such strategic competitors as China to minimizing the threat from terrorism. On Aug. 30, she discussed the first term and the outlook for a second with Chief Diplomatic Correspondent Stan Crock.

What did you learn over the last 3½ years?

When this President came into office, nobody would have expected the earthquake that was September 11. It was a life-changing experience for all of America. The primary lesson was that you can't afford to let threats gather. It led us to understand the need for the ability to intervene and even reconstruct, in ways that I think were quite unexpected for this country.

Is there a tradeoff between efficient U.S. action and international legitimacy?

I wouldn't put it in those terms. It is at some level efficient to have the U.S. try to solve something on its own. It's not always effective to do it that way. And it's not just a matter of legitimacy; it's a matter of what is effective.

What can we do about North Korea's and Iran's nuclear capabilities?

I think what you can see is that the international community does not want a nuclear weapons-capable North Korea, and they don't want a nuclear Iran. What you have to do is confront countries with a very stark choice—that you give up your nuclear weapons ambitions or you face isolation.



Is regime change the ultimate answer?

Would it be better for the North Korean people if that regime were not in power? Of course. Or the Iranian regime for that matter. But there are ways to focus pressure on regimes to take care of the near-term security threats that they pose. And to stay firm about the aspirations of their people so that over time, pressure may come from within.

What are the plans for Iraq?

The military is trying to provide a secure environment. But it's the political strug-

gle that matters. And every day that that political process moves ahead, the fundamental structures in Iraq get stronger.

Given the intelligence and planning failures in Iraq, does this national security team deserve a second shot?

I don't know about the national security team, but the President does. If anybody wants to tell me, whatever you think about Iraq, that the world is not safer having taken down the Taliban, having taken down Saddam Hussein, winning Pakistani and Saudi Arabian cooperation in the war on terrorism—that's a record I think this President is prepared to run on.

Why isn't Iran a candidate for preemption, like Iraq?

I don't think Iraq was preemption. I think preemption actually would have been to go after Afghanistan prior to September 11. Iraq was a universe of one. Saddam Hussein had invaded his neighbors twice. He'd used weapons of mass destruction before. That puts him in a class by himself. He had a massive effort to build weapons of mass destruction and then to conceal what he had been doing. We were in a state of suspended hostilities, and he was paying \$25,000 to suicide bombers. And he was under international sanctions, which either needed to be removed so that the Iraqi people could live—because they were really hurting the Iraqis—or you had to deal with him.

The Iranians may eventually get themselves to international outlaw status, but they haven't quite gotten there yet. So different circumstances, different means.

Do you see any Administration failures?

We thought the Iraqi military would stand and fight. They didn't. They melted. That led to the insurgency. And transferring sovereignty to an interim authority—when Iraqis opposed a long occupation—was a shift. Maybe it was foreseeable—I don't really think so. When dealing with complex events, things don't go exactly as planned. We changed and adapted. ■

BusinessWeek online For an extended Q&A with Condoleezza Rice, go to businessweek.com/magazine/extra.htm.

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COMMENTARY

BY LOUIS LAVELLE

Lessons of the 'Hollinger Chronicles'

There are always signs of trouble. Here's what investors should look for

THE INDEPENDENT board report on Conrad Black's reign at Hollinger International is like a blast from the past. While the rest of the corporate world has been dutifully embracing governance reform and beefing up board procedures, Black was blithely using the company he controlled through a minority stake as his personal ATM, as detailed in the report.

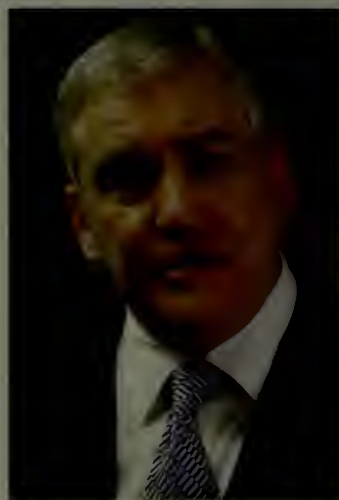
Apparently, Black didn't get the message that greed was out.

The "corporate kleptocracy" that flourished there, according to the report, allowed Black and his associates to pocket more than \$400 million in seven years—almost every penny of profit Hollinger earned. And it has vaulted Black into the pantheon of corporate gluttons, right up there with Dennis Kozlowski, Bernie Ebbers, and Ken Lay. Black's company denies the allegations. In hindsight, all such spectacular scandals look glaringly obvious, with plenty of red flags to warn off investors. The Hollinger case—which featured a pocket-lining CEO, an "ineffective and careless" board, and a corporate structure that made Hollinger ripe for the picking—is instructive for investors eager to avoid the next debacle. Four lessons from the "Hollinger Chronicles" stand out:

BEWARE OF CEOs WITH A CONTROLLING STAKE. Black owned only a sliver of Hollinger International, but under the two-tier stock structure, each one of his shares entitled him to 10 times the voting power of lesser public shareholders. That, the report says, allowed him to control Hollinger "absolutely."

Among recent flameouts, Adelphia Communications Corp. also had a two-tiered equity structure. Governance experts say companies with dual stock classes like Hollinger are a bad bet for shareholders. They often lack the kind of independent boards that are needed as a check on managerial excess.

KEEP AN EYE ON EXECUTIVE PAY. Warren E. Buffett has called executive pay the acid test of governance. It's a test Hollinger failed. In addition to approving transactions that funnelled nearly \$300 million to Black & Co., and turning a blind eye to his profligate use of perks, the company, according to the report, failed to disclose 96% of the pay received by the top five executives from 1996 to 2003. That kind of poor disclosure



BLIND EYE? Perle, left, was on the board that gave Black free rein

curiosity." But the Hollinger board, consisting of Black's social, business, and political pals, seemed tuned out. According to the report, the executive committee didn't discuss—or even read—documents it was signing that approved transactions benefiting Black and costing Hollinger millions. "It is difficult to imagine a more flagrant abdication of duty," the report states.

When a board is hand-picked by the top dog, shareholders need to be especially on guard. Hollinger's board was star-studded: It included Henry A. Kissinger, former Secretary of State, and national security expert Richard N. Perle. But clearly it didn't make the effort to put Hollinger and Black under the microscope.

COMPLEXITY SHOULD SET OFF ALARMS. Before Enron's collapse, Kenneth L. Lay and Jeffrey K. Skilling won accolades for turning a slow-growth utility into a hot energy-trading business. Few outside the company understood what they were doing, but who cared? Enron was booking big profits, and the stock was soaring.

Hollinger's structure and pay schemes were likewise impenetrable. Black controls Hollinger through Ravelston, a holding company that owns 78% of the stock of Hollinger Inc., which controls a majority stake in Hollinger International. Hollinger International paid Ravelston management fees—wildly excessive, according to the report—that were allocated to Black and others. In addition, Hollinger paid Black and others "noncompete fees." As a result, even the most diligent shareholder would be hard-pressed to figure out who got what. One thing is painfully clear, though: Conrad Black and his pals got plenty. ■

raised the suspicions of institutional investors and led to Black's unmasking. But a closer examination of the perks the company did disclose should have raised more eyebrows. Black received more than \$248,000 in perks in a single year, including directors' fees, maintenance for homes in New York and Chicago, cars and drivers, and his personal use of corporate aircraft.

THE BOARD MATTERS. Directors, says governance activist Nell Minow, have a "duty of

A photograph of a pregnant woman and a man standing in a nursery. The woman is on the left, wearing a light-colored button-down shirt, and the man is on the right, wearing a dark long-sleeved shirt. They are both looking directly at the camera. The background is filled with various baby items, including strollers, cribs, and shelves with toys.

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SOFTWARE

WHEN MICROSOFT CAN'T DO WINDOWS

The delay in shipping Longhorn betrays major R&D troubles

WHEN MICROSOFT Corp. announced on Aug. 27 that its next version of Windows, code-named Longhorn, would ship as much as a year later than expected, in late 2006, the company downplayed the news. Don't be fooled, because the setback is, in fact, a big deal. For one thing, it could damage the reputation of Chairman William H. Gates III, who put more than a third of his time into the project since he became the company's chief software architect in 2000. It also means there won't be advances in the operating system for at least the next two years. That means customers will have one less reason to buy new PCs. And it gives an opening to the software giant's rivals, who are going after Microsoft as if it were an aging prizefighter. With every Microsoft misstep, their offerings become more attractive to both consumers and corporations.

The Longhorn mess points to a recurring problem at Microsoft: Hypo often gets way ahead of the company's computer science. "The priority is more on marketing than development," says Alan Paller, research director at the SANS Institute, a computer security training organization. That doesn't bode well for a company that hopes to lead the computer industry in the 21st century.

With Longhorn, as with other past products, Microsoft talked up a technology it couldn't quite deliver. It set out to overhaul a central piece of desktop com-

puting—the way users search and store information. But it proved too difficult a challenge—especially at a time when it is under tremendous pressure to make its current version of Windows safe from a plague of viruses, worms, spam, and pop-up ads.

TWO-YEAR WINDOW

Often criticized for its lack of innovation, Microsoft might have hushed naysayers had it pulled off the much anticipated Windows File System feature of Longhorn. Shelved at least for a while, WinFS would have made it much simpler for computer users to store and search for everything from e-mail to spreadsheets to Web pages on their computer, a network, or the Internet. It's still a long-term goal. "We're not going to temper our ambition," says Will Poole, senior vice-president of the Windows client business.

The news that Longhorn is late has Microsoft rivals licking their chops. They have a two-year window of opportunity to improve their products and win over customers. "Microsoft is continuously promising these advancements but isn't able to deliver on the promises," says Mike Ferris, product marketing manager at Red Hat Inc., which sells the rival Linux operating system. "Now customers can look at how non-innovative this is going to be, and they can look at open source as an alternative." Red Hat, one of the leaders in Linux software

THE STAT

5

Years it will have taken Microsoft to introduce its new Longhorn operating system, scheduled for release in 2006



KILL BILL?
Gates's rivals smell blood

for server computers, in August started selling a desktop version for a subscription cost of less than \$6 per user per year.

Some in the industry believe that Microsoft could learn from one of its rivals—Apple Computer Co. (page 96). The Mac maker does a great job of keeping both its new hardware and software under wraps, then thrilling its fans with whizzy breakthroughs—something it did once again in late August with the unveiling of its gorgeous new iMac computer. In contrast, when Microsoft doesn't deliver on its promises, it loses credibility with PC makers, software publishers, and customers.

Last spring, as the first signs of Longhorn delays emerged, techies began referring to the operating system as Longwait. Now, with WinFS cut, critics have renamed the software Shorthorn. The name-calling poses no threat to Microsoft's hegemony. But its stumble with Longhorn gives rivals an opening at a time when Microsoft needs to get its business revving again. ■

—by Jay Greene in Seattle



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EDITED BY MONICA ROMAN

HEADLINER

JAMES TOBIN



FEELING BETTER

CEO James Tobin has **Boston Scientific** on the mend. On Sept. 1, the medical-device maker said sales of its Taxus Express2 drug-coated stent, a device used to prop arteries open after angioplasty, were rebounding after a series of recalls. "We are emerging from August in a much better position than I think most people would have thought," Tobin told analysts.

Boston's share of the drug-coated stent market (the coating reduces the risk of arteries reclogging) fell as low as 55% in July after the recalls, but has since climbed back to more than 65%. Rival **Johnson & Johnson**, which makes the only other drug-coated stent sold in the U.S., has been slow to exploit Boston's problems due to manufacturing woes. "They were lucky J&J couldn't respond immediately," says Merrill Lynch analyst Daniel Lemaitre.

And while the Natick (Mass.) company did lower its earnings forecast for the rest of the year, investors were relieved stent sales are back on track. Boston's shares rose 7%, to \$38.28, on the news.

—Amy Barrett

NEW ULCERS FOR MERCK

Merck's ailments are mounting. On Aug. 30, a study of the company's \$5 billion cholesterol-lowering drug Zocor revealed that high doses of the drug didn't benefit patients who have an elevated risk for a heart attack. It also showed that those higher doses increased the risk of a dangerous muscle side effect. While industry analysts don't expect the news to trigger a big falloff in Zocor sales, it will certainly be ammunition for sales reps from archrival **Pfizer**, which sells the \$10 billion cholesterol medication Lipitor. The bad news about Zocor comes on the heels of another study that linked Merck's blockbuster painkiller Vioxx to a higher risk of heart attacks than a competing drug from Pfizer.

THE IPOD'S BIG BROTHER



Judging from the latest iMac desktop model, **Apple Computer** seems to be taking its style cues from the iPod, its wildly successful digital music player. The new iMac G5, unveiled on Aug. 31, stuffs all the PC innards right behind a flat-panel display. Besides saving space, it gives the appearance of an overgrown, two-inch-thick, stretched-out iPod. While the design is revolutionary,

analysts aren't sure it will win over the millions of iPod owners who use Windows PCs. The new G5 is priced at \$1,299 to \$1,899, so Apple still isn't addressing the sub-\$1,000 segment that dominates PC sales. And supplies of the new iMac could be tight, due to shortages of **IBM's** G5 microprocessor.

JUST TOO MANY WHEELS

General Motors and **Ford Motor** were hoping brisk sales in August would help thin out their fat inventories. But it didn't happen, as gas prices near \$2 a gallon softened demand (page 102). GM sales fell 7% and Ford's volume dropped 6%. GM has been racing to reduce inventories for most of the year, but they remained at 1.15 million vehicles at the end of the month—15% above last year's stocks. That means consumers can expect rebates and cut-rate financing deals to continue and both companies will have to slow down their assembly lines. GM says it will cut production by almost 7% in the fourth quarter, and Ford will do so by almost 8%. Meanwhile, **Chrysler Group's** sales rose 1%.

MORE NET PHONE TIEUPS

The Internet calling wave keeps surging. **AT&T** announced on Sept. 1 that it will co-market voice over Internet protocol, or VoIP, and cable broadband with cable operator **Adelphia Communications**. AT&T can now provide VoIP service, which routes calls over the Net rather than traditional phone lines, to 170 U.S. markets. Similarly, cable

provider **Charter Communications** teamed with **Sprint** on Aug. 31 in a VoIP deal. Currently, more than 600,000 Net subscribers use commercial VoIP services, but with companies aggressively rolling out service, that number should hit 17.5 million by 2008.

ET CETERA...

» The two bidders for **MGM—Time Warner** and **Sony**—expect to get word soon after Labor Day.

» **eBay** spent \$325.6 million to hike its stake to 86% in South Korea's largest online auction company.

» **Charles Schwab** will sell its institutional investing arm to Swiss bank **UBS**.

CLOSING BELL

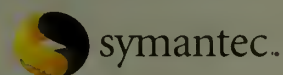
Shares of **Forest Laboratories** slid 8.4% on Sept. 1, to \$41.98, after it said that Alzheimer's patients in a late-stage clinical trial of its experimental drug neramexane failed to show improvement. Nevertheless, Forest still plans to continue work on the new drug.





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EDITED BY RICHARD S. DUNHAM

Can Lawyer-Bashing Win Votes for Bush?

ON NOV. 2, SEATTLE NEUROSURGEON and lifelong Democratic supporter Steve Klein will do something he has never done before: Vote Republican. He's not driven by terrorism, taxes, or even the cost of health care. "I've never pulled the lever for a Republican candidate in my life," Klein says. "But this time, I'm voting for who will vote for reform."

That would be President George W. Bush. Klein is going against Democrat John Kerry because he's hopping mad about "lawsuit abuse" that has jacked up the cost of medical malpractice premiums and forced some physicians to flee states where rates are particularly onerous.

As the race for the White House shifts into high gear, Republicans and their business allies are aiming to win over some Democrats by demonizing trial lawyers as litigious leeches who hurt average consumers as well as corporations and doctors. They are giddy that Kerry picked as his running mate John Edwards, a well-heeled, well-coiffed millionaire lawyer. "The Democratic Party is the party of trial lawyers," says Bush campaign manager Ken Mehlman. "People...have less access to [health care] because a few people are getting very rich."

That strategy is sure to win Bush the votes of some doctors who might have considered voting Democratic in retaliation for the GOP's close ties to the insurance companies that have been squeezing them. And it will rally Bush's base, especially small-biz owners and corporate execs who have made legal reform a top priority. Although it is not endorsing either candidate, on Aug. 24 the U.S. Chamber of Commerce gave \$500,000 in seed money to The November Fund, a group dedicated to warning voters about the dangers of putting the trial bar's favorite son in the White House. A group of former Edwards staffers is planning a counterattack funded by plaintiff lawyers.

But the political reality is that Bush's anti-

lawyer rhetoric cuts both ways. As despised as the stereotypical ambulance-chaser is, many blue-collar voters worry about the excesses of unchecked corporate power and see the courts as the only recourse for defending their rights.

Edwards—who won fame and fortune by representing average folks against insurance companies, hospitals, and corporations—may not be Exhibit A in the case against greedy lawyers. "Nobody could be a better advertisement for the plaintiff's bar in America than John Edwards," says shareholder lawyer Melvyn I. Weiss, who raises funds for Democrats. Business sees the situation differently. "If the trial lawyers' associ-

ation were to have a poster child, I don't know who would fit better [than Edwards]," says Jack Faris, CEO of the National Federation of Independent Business.

However, polls suggest the issue isn't resonating. A CNN/USA Today/Gallup Poll just after Edwards' selection found that 69% of voters said his profession would not affect their choice. Says Univer-

sity of Texas political scientist Bruce Buchanan: "There's just not much sentiment for tort reform outside hard-core Republicans."

Yet even they don't necessarily vote that issue. In Florida, former Housing & Urban Development Secretary Mel Martinez trounced six rivals in an Aug. 31 GOP primary despite attacks on his background as a personal-injury lawyer who won million-dollar verdicts. The victory for Martinez, who ironically was handpicked by the White House, suggests that the polls may be right and tagging Kerry/Edwards as the trial lawyer team won't do major damage. ■

—By Lorraine Woellert



THE GOP wants to make Edwards the poster child for litigation abuse

CAPITAL WRAPUP

HOUSE OF SAUD, HOUSE OF BUSH DEPT.

Relations between the Bush and al-Saud clans have long been cozy—and complaints by some Washington conservatives about the involvement of Saudi citizens and money in September 11 haven't fundamentally changed that. There's no ambiguity among leading princes in Riyadh when it comes to the U.S. Presidential elections: "It's Bush all the way," says a senior member of the House of Saud. According to this prince, the 1.3 million barrel-a-day increase in Saudi oil production, announced on Aug. 11, was designed in part to give a boost to George W. Bush—although Riyadh would have eventually moved to damp down soaring prices. What's more, senior members of the Saudi royal family, including effective ruler 80-year-old Crown Prince Abdullah, were offended by Democratic nominee John Kerry's perceived anti-Saudi statements at the Democratic Convention. "He almost singled us out by name," grouses the prince.

PICK OF THE INVESTOR CLASS?

Who's the best candidate for the markets? Investors surveyed by the Gallup Organization favor President Bush—but not by much. The Republican incumbent's 41%-35% lead over Kerry has a four-point margin of error. (The rest—21%—said it doesn't matter who wins.) But Bush is clearly capturing the optimists' votes: Those who say four more years would be best for markets register a strong 184 score on the UBS/Gallup Index of Investor Optimism, while those who say Senator Kerry will boost investments score a negative 17 for optimism.

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RUSSIA

GETTING PAST YUKOS

Sure, the Khodorkovsky affair is a mess. But that won't keep Big Oil from pouring money into Russia

FOR MUCH OF THE PAST year, Russian President Vladimir V. Putin has been on a mission to take down Mikhail B. Khodorkovsky, the former CEO of the country's second-largest oil company, Yukos. The only time the fallen oil baron is allowed out of his Moscow jail cell is when he's sitting behind bars inside a cramped cage in a federal courtroom, where he is on trial for what many consider politically motivated charges of fraud and tax evasion. Soon the company itself will be destroyed, as the government seizes core assets with the aim of selling them off. The Russian stock market has fallen 25% since early April.

So who in the world would want to invest in Russian oil right now? Conoco-Phillips, that's who. And Exxon Mobil

Corp. And Royal Dutch/Shell Group. And BP PLC. In fact, at a time when oil prices are spiking and new fields are scarce, the global oil companies are looking hungrily at Russia despite the Yukos debacle. Acts of terrorism, gruesome as they are, don't seem to deter them, either. Conoco, for instance, is ready to bid at least \$1.9 billion on Sept. 29 for the government's remaining 7.59% stake in Lukoil, Russia's largest oil producer. "We'd like to be a major player in Russia," Conoco CEO

James J. Mulva said in July after meeting with Lukoil Chairman Vagit Y. Alekperov and Putin in Moscow.

The bidding for the Lukoil shares is open to other Russian and foreign companies. But Mulva's meeting with Putin, plus Conoco's former partnership with Lukoil in the Polar Lights project in northern Russia, lead many to believe that Conoco has the edge. There is speculation that the 7.59% Lukoil stake could be just the start, with Conoco

Oil Rush

Major foreign investors in the Russian oil industry



YUKOS DERRICKS

Moscow plans to sell off core assets

lion a year over five years. "For us it has been full steam ahead," says Robert Dudley, CEO of TNK-BP. Profitable, too. BP says the gross dividends from TNK-BP this year will exceed \$2 billion.

Shell, meanwhile, recently approved a \$1 billion investment into the Salym oil field in western Siberia, where it operates a venture with Russian independent Evikhon. Shell is also a 55% shareholder of Sakhalin II, which began production in 1999 off Russia's Pacific coast. Last year Sakhalin II won shareholder approval to proceed to its second, more ambitious \$10 billion phase.

Even Exxon, which was on the verge of buying a big stake in Yukos when the company's woes began last fall and which is fighting the government's move to revoke its rights to develop the big Sakhalin III project, isn't sour on Russia. It controls a 30% stake in Sakhalin I, which will eventually require some \$12 billion in investments. "We see Russia as having great potential in the oil and gas business," says a spokesman.

In fact, Russia's reserves may be far larger than the standard estimates suggest. According to the U.S. Geological Survey, some 21% of the world's undiscovered oil—an additional 171 billion barrels—is in the former Soviet Union. While most Russian oil production is in western Siberia, interest is shifting toward largely undeveloped eastern Siberia. "The last oil frontier is going to be east Siberia," says Ronald Smith, an analyst at Renaissance Capital in Moscow. Eastern Siberian reserves could be as much as 51 billion bbl., according to United Financial Group.

Russia's reserves are cheap as well as plentiful. The \$1.9 billion starting price tag for 7.59% of Lukoil works out to \$1.70 per bbl., well below the \$4.94-per-bbl. average acquisition cost in the West, says Renaissance Capital. Extraction costs are low, too—some \$2 a bbl., vs. \$1 in Saudi Arabia, compared with a global average of \$4 to \$5. It helps that most Russian oil is onshore and that surveys have revealed where much of that oil is, so it's relatively easy to get at. "There's no danger of drilling a bunch of dry wells," says Smith.

Adding to the attraction, Siberia bor-

Energy Rich

Russia has the largest gas reserves in the world, and its oil reserves may be far greater than current estimates

OIL	GAS
69.1	276.6
BILLION BARRELS	BILLION BARRELS*

Data: BP Renaissance Capital

*oil equivalent

ders China and the economies of eastern Asia—the very markets that are set to drive global oil demand in the decades ahead. Although a lack of export pipelines could curb Russia's export growth over the next few years, the government looks set to give the go-ahead to a \$10 billion pipeline to the Far East, with a capacity of 1 million bbl. a day, that should be up and running by the end of the decade. Meanwhile, Russian oil production is set to rise 8% this year.

Little wonder the oil majors are interested. The bigger issue may be how to invest. Apart from the Lukoil deal, acquisition targets are scarce. France's Total was rumored to be eyeing a 25% stake in Sibneft, Russia's No. 5 producer. But Sibneft may be the last company on offer. Increasingly, foreign investments are likely to be project-specific ventures.

For investors, working in partnership with Kremlin-backed companies is one way to mitigate the political risks. For the state, they're a means of bringing in Western capital and expertise without losing control over the industry. But the new model brings risks as well. The fear is that the state's growing clout will kill the sector's dynamism, which has been driven largely by privatized companies. If the Kremlin ends up putting political considerations before commercial ones, the results could be ugly—as the Yukos fiasco illustrates. For now, though, these are risks that reserve-thirsty investors such as Conoco may just have to live with. ■

—By Jason Bush in Moscow, with Wendy Zellner in Dallas and Stanley Reed in London

eventually upping its holdings to 25%.

The oil companies' growing enthusiasm for Russia may seem puzzling, given the continuing legal and political risks. On the other hand, the lessons from the Yukos affair seem clear enough. Yukos' troubles are widely attributed to the political ambitions of Khodorkovsky. In other words, stay on the right side of the Kremlin, avoid meddling in politics, and you should be O.K. "You obviously need political support [from the Kremlin] to do big deals in Russia," says Stephen O'Sullivan, co-head of research at Moscow investment bank United Financial Group. For Putin, a successful sale of its last small stake in Lukoil would be one way to mitigate some of the damage done to Russia's image by the Yukos conflict.

"FULL STEAM AHEAD"

BP AND SHELL certainly aren't shy about pumping more money into Russia. Last year, BP paid \$8 billion to form a 50-50 venture with Russia's TNK oil company. The venture, TNK-BP, plans to invest \$1.4 billion on upgrades and exploration this year, all from cash flow, and at least \$1 bil-

BP

Paid \$8 billion for a 50% share of TNK-BP, Russia's third-largest oil company, which produces 1.46 million bpd.*

EXXONMOBIL

Owns 30% of Sakhalin I in the Pacific, which has reserves of 5 billion barrels of oil equivalent.

CONOCOPHILLIPS

Operates the Polar Lights project, a joint venture with Rosneft that pumps 36,000 bpd.* Eyeing a 7.59% stake in Lukoil.

ROYAL DUTCH/SHELL

Owns 55% of Sakhalin II, pumping 70,000 bpd,* plus 50% of the Salym field in western Siberia.

TOTAL

Operates the 14,000-bpd* Kharyaga field in northern Russia and is exploring the Shatsky field in the Black Sea with Yukos.

Data: Renaissance Capital, BusinessWeek

*barrels per day

COMMENTARY

BY BRUCE EINHORN

Now Spam Is Being Outsourced

Spammers are flocking to Korea and China. Will governments take action?

EVERYONE KNOWS THAT China and South Korea have become export powerhouses for everything from baseball gloves to semiconductors. But watch out, world:

The Asian powers are fast becoming major exporters of an item you don't want to import—Internet spam. In early September, Chinese officials were scheduled to hold an antispam summit in Beijing with top executives from some of America's biggest Net companies, including America Online Inc., eBay, Yahoo!, and Microsoft. With reason: More than 25% of the junk e-mail sent around the globe now originates from servers in China and South Korea. "It won't be long before China produces the same amount of spam as the U.S.," frets York Ma, chairman of the Hong Kong Internet Service Providers Assn.

This is one export Asia—especially China—has to curtail fast. If not, it could endanger the security of the global Net. Junk e-mail dangerously clogs the cyberways, of course. Net executives worry, too, that spammers using China as a base will team up with hackers and virus writers, which would be "very destructive," says Li Boda, e-mail manager at Chinese portal Sohu.com.

What's frustrating to many companies is that governments have been slow to react even as Asian spam has been growing explosively. A survey by Sophos PLC, a British Internet security firm, found that between February and August of this year, the flow of junk e-mail coming out of China and Hong Kong almost doubled, from 6.24% of the global output to 11.63%, while the amount from South Korea went from 5.8% to more than 15%.

Some spam conveyors are renting servers in China, but others are remotely hijacking Asian PCs without their owners' knowledge to use as vehicles for transmitting billions of e-mails. Spam artists are moving operations to Asia to avoid a crackdown in the U.S. Internet service

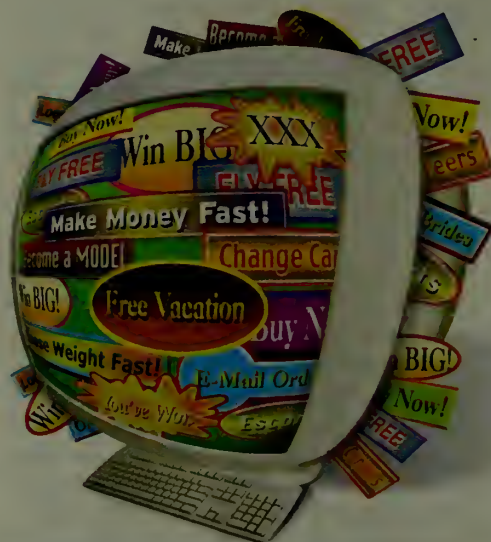
providers such as AOL and EarthLink Inc. have filed suits against spammers. The so-called Can Spam Act, which took effect in January, has erected new legal hurdles. "As crackdowns are happening in the U.S., spammers are going offshore," says Gregg Mastoras, senior security analyst at Sophos. "Mostly it involves being in an environment where nobody is going to come shut you down."

Why Asia? South Korea has the world's most advanced broadband infrastructure, allowing spammers to take advantage of its high-speed connections. And China, while it boasts fewer broadband hookups, is largely unregulated. "China is a safe harbor for spammers," says Andy Lake, director of sales and operations for Greater China and Southeast Asia for MessageLabs, the British e-mail security company. "There's not a lot of control over the infrastructure." Asia's rise as a spamming center is drawing the attention of industry big guns. "What we really need to do is agree across all nations what are the areas that are wrong no matter where you are," says Ryan Hamlin, general manager for antispam technology and strategy at Microsoft Corp.

Asian governments are getting the message, partly due to Microsoft and others, and partly because spam is starting to be a problem for local users as well. Seoul regulators plan to propose antispam legislation this fall that includes fines of up to \$26,000 for offenders: More than 60% of all e-mail messages received by Internet users in Korea are spam. China's Ministry of Information Industry announced in July that the government was drafting new legislation. "China is now much more security-aware," says Peiyin Pai, a senior manager for Computer Associates International Inc.

Will the new initiatives end the threat of spam from the East? "China alone cannot fight spam," says Li Yuxiao, head of the antispam group at the Internet Society of China. Spam is a global blight, one that the West hasn't figured out how to address either. But making it hot for spammers in Asia will certainly help. Free trade in spam is the last thing the world needs. ■

With Chen Wu in Hong Kong, Brian Grow in Atlanta, and Moon Ihlwan in Seoul



Junk from the East

Spam from China and Hong Kong is growing fast

FEBRUARY 2004

6.24%*

AUGUST 2004

11.63%*

* share of spam originating from Hong Kong and China

Data: Sophos PLC

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Get it all scanned in.

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Get more efficient.

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Get multifunctional.

Get it done.

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JAPAN

BUY A TOYOTA, GET A MORTGAGE

The auto giant is setting up a bank and eyeing the consumer credit markets

JAPAN'S NO.1 AUTO MAKER isn't known in business circles as the "Bank of Toyota" for nothing. With a war chest of \$30 billion and ample access to cheap bank loans and bond capital, Toyota Motor Corp. has plenty of money to spend on developing exotic new technologies, from hybrid engines to resins derived from sweet potatoes. But for all its money—much of it parked in low-interest-bearing accounts in Japan—Toyota hasn't moved aggressively into financial services, which account for less than 10% of its profits. One reason: carbuyers in Japan typically pay cash instead of financing their purchases.

In the U.S., however, Toyota is starting to flex its financial muscles. It already provides lots of plain-vanilla car loans through its U.S. financial arm, Torrance (Calif.)-based Toyota Financial Services. That unit has grown in step with the company's record vehicle sales growth and has quietly become the third-largest "captive"

loan operation in America after General Motors Acceptance Corp. and Ford Motor Credit Co. Its assets have doubled in the past five years to \$45.9 billion, making it the U.S.'s eighth-largest speciality financing company. For the year ended in March, TFS had record profits of \$729 million, up 43%, on revenues of \$2.7 billion. Toyota, content before to let dealers choose their banks, has made a big push over the past five years to bring showrooms into the TFS fold.

But Toyota's finance engine is just

CALIFORNIA DREAM
Toyota may offer credit cards and home financing

revving up. Now the auto maker is looking to leverage its industry-leading credit ratings

into a wider range of financial products. "We're in a very fortunate situation," says TFS President George Borst. "We represent a company that is the only triple-A borrower in the [auto] business."

STARTING SMALL

AS A FIRST STEP, the carmaker received approval from the Federal Deposit Insurance Corp. in August to set up a full-fledged bank in the U.S. under the name Toyota Financial Savings Bank. Capitalized at \$10 million, the Nevada-headquartered bank was established on Aug. 16. It's starting small, with a pilot program that provides cash management services to a few Toyota dealers on the West Coast. If that goes smoothly, the company gradually plans to roll out a range of services, including credit cards and unsecured loans. The goal is to offer one-stop shopping for financial services: Imagine, for example, getting one statement a month from Toyota tracking your car, mortgage, and credit-card payments.

Is Toyota angling to create the equivalent of GMAC, which does everything from issue mortgages to invest in Japanese nonperforming loan workouts? Not yet. The chief goal is to enhance brand loyalty among its existing 2.3 million auto loan and enhanced-warranty customers with a convenient way to manage their finances. There may be further incentives. In Japan, users of Toyota credit cards earn points for discounts on future car purchases and vehicle inspection fees. "We want to lock them in," says Borst, a 19-year Toyota veteran who formerly ran the Lexus luxury car division.

After years of fast growth, Toyota is nipping at Ford Motor Co.'s heels for the No.2 spot in vehicle sales. But its rapid growth in the auto market can't last forever. Once that matures, loyalty to the Toyota bank will be a valuable asset. A stretch? Maybe. But with \$30 billion in the

till and a gilt-edged credit rating, Toyota now looks stronger than most traditional banks. Watch for those mortgage offers at a dealership near you. ■

—By Chester Dawson in New York

The Big Three

The Big Three				
COMPANY	NET PROFITS (2003)	TOTAL ASSETS	MOODY'S CREDIT RATING	PERCENT OF PARENTS' PROFITS EARNED
	BILLIONS			
GMAC	\$2.8	\$300	A3 negative	62%
Ford Motor Credit	1.8	129	A3 negative	95
Toyota Financial	0.7	46	Aaa stable	6
Data Business Week company reports				

Data: BusinessWeek company reports



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STUCK WITH THE BILLS
Dana Christensen claims she and her late husband were sold a "sham" policy

It's Enough To Make You Sick

Scams are proliferating as more families scramble for affordable health coverage

THE WAY DANA CHRISTENSEN sees it, she and her husband got scammed. In early 2001, seven years after Doug had successfully battled bone cancer, the couple needed new health insurance. So they were all ears when a representative from a group called the National Association for the Self-Employed knocked on the door of Doug's boat repair business in Marina del Rey, Calif. The rep offered what sounded like a great deal: For

just \$434 a month, MEGA Life & Health Insurance Co. would cover them both. The policy even carried a chemotherapy rider in case Doug's cancer came back.

But when the cancer did return later that year, they received a shock: A few months after Doug started chemotherapy, Cedars-Sinai Medical Center refused to treat him anymore, saying he had already used up the MEGA coverage. The problem: It capped chemo coverage at \$1,000 a day, even though Doug's cost up to \$18,000—fine print Dana says they were

never told about. The doctor got Doug transferred to another hospital. But after he died in October, 2002, at the age of 48, Dana was stuck with almost \$500,000 in medical bills that MEGA refused to cover and now lives on her boat to save money on rent. "He said to me one day, 'I know it's too late for me, but this should not happen to people,'" recalls Dana, who says the NASE rep never told them that it functions as MEGA's marketing arm and only sells MEGA insurance. Last year, she sued MEGA and NASE for failing to disclose the caps and for endorsing a "sham" policy by pretending NASE was an independent group.

NASE President Robert Hughes says that "we are separate [from MEGA] and always have been separate." However, he also says that its representatives have dual roles and sell both NASE memberships and MEGA policies. In a written response to *BusinessWeek*, MEGA's parent UICI Inc. of North Richland Hills, Tex., said: "We believe the Christensens' coverage was properly represented to the consumers." On Aug. 18, a California judge denied a motion by MEGA and NASE to dismiss the Christensens' case. A trial on charges of fraud and unfair trade practices is set for January, 2005.

The U.S. today is awash in these and

Working-from-Home Walter now gets more done in slippers than in wingtips.

NAME: Working-from-Home Walter

QUOTE: "Who says I have to be *at work* to be *hard at work*?"

CHALLENGE: His company needs him. His family needs him.

NOKIA'S ANSWER FOR I.T.: Nokia Secure Access System



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other kinds of insurance disputes. Across the country, insurers are pitching a kaleidoscope of plans that collect millions in premiums and fees but don't pay all claims or serve up shabby service (table). This summer alone, Montana has issued 15 cease-and-desist orders against medical discount plans hawking coverage for \$89.95 a month, no questions asked. In Florida, officials have shut down 200 fake insurance operators in the past two years. In February, the General Accounting Office found that 144 unlicensed health insurers covering 200,000 people have left \$252 million in unpaid medical claims in recent years. Overall, health-care fraud cost \$54 billion in 2003 and is growing by at least 3% a year, according to the National Healthcare Anti-Fraud Assn., a nonprofit group in Washington, D.C.

Driving the trend is a punishing combination of soaring health-care costs and shrinking employer coverage. The ranks of uninsured Americans jumped again last year, by 1.4 million, to 45 million, according to new data released Aug. 26 by

the Census Bureau. As more families are tossed out of employer coverage, they're left to fend for themselves in the bewildering world of health insurance.

Indeed, the number of consumers buying medical policies on their own has jumped by nearly 1.5 million since 2000, to 17.5 million last year (chart, page 61). Given the crushing cost of family coverage, increasingly desperate Americans are susceptible to anyone who has a deal to offer. "We have an availability and an affordability issue—and that's when scams proliferate," says Florida Chief Financial Officer Tom Gallagher, who oversees insurance regulation in the state.

Nor is the problem easy to fix. Some, such as fake health insurers and bogus Medicare drug cards, are outright illegal. Others, like NASE and MEGA, claim legitimacy, saying they play a dual role by providing insurance as well as market-

Some operators just dash from one state to another

ing it, even though NASE doesn't always tell would-be members like the Christensens that it serves as the insurer's marketing arm. Many take advantage of a crazy quilt of regulations that often allows them to skirt legal oversight. For example, 40 states exempt associations such as NASE from state insurance laws if they provide other benefits to members besides in-

surance, such as travel discounts.

Trouble is, few states police such associations to determine their legitimacy. The Bush Administration's plan to push medical savings accounts managed by private firms could make the problem worse, some critics say, by placing more responsibility for health-care costs in the hands of individuals. "There is potential for real harm in this marketplace," says Kansas Insurance Commissioner Sandy Praeger, who chairs the health insurance committee at the National Association of Insurance Commissioners (NAIC). Even so, support for federally regulated association plans (AHP) is growing. AHP legislation has been approved by the House of Representatives, and the GOP platform calls for its passage.

Health Coverage Hell

Regulators say some allegedly unscrupulous health insurers and medical discounters are hoodwinking consumers. A few popular tactics:

FAKE POLICIES

Targeting individuals, small businesses, and the self-employed, these scams hawk professional-sounding plans with ultralow rates using slick marketing, many claiming to be exempt from state laws. Since 2001, just five bogus insurers have left more than 85,000 people with at least \$85 million in unpaid medical claims. Florida alone has shut down more than 200 unauthorized operators in the past two years.

CUT-RATE PLANS

These supercheap medical plans are often marketed as if they were insurance, offering "group coverage" for as little as \$89.95 a month. But often their advertised networks don't exist. Because state insurance regulators in most states have no jurisdiction over noninsurance products, they're hard to patrol. Montana issued 15 cease-and-desist orders in the past six weeks against such discount plans.

ASSOCIATIONS

Regulators say that some health insurers market policies through associations that claim they're independent but often aren't. Their alleged independence often exempts them from state insurance laws, allowing big unexpected rate hikes. An estimated 6 million people are covered by such association group insurers. Some of these associations, however, insist they are entirely legitimate.

DISCOUNT DRUG CARDS

Preying primarily on the elderly confused about new Medicare prescription drug benefits, a rash of drug card scams has hit at least 11 states since the new Medicare law went into effect on June 1. The Federal Trade Commission recently sued one company for allegedly attempting to steal more than \$10 million from the checking accounts of 90,000 people.

SOPHISTICATED SCHEMES

WHAT PARTICULARLY TROUBLES state authorities is how sophisticated many schemes are. Three years ago, Florida insurance investigator Vincent Mazzara began scrutinizing an alleged scam by a company called Insurance Maternity Consultants Inc., whose headquarters is listed as a mailbox drop in Miami. The owner, Angel Alcedes Golindano, marketed health insurance to pregnant women, mostly Hispanics. He duped them into paying \$3,000 per policy, officials say, by claiming he had found a loophole that excluded pregnancy for unemployed women from being a preexisting condition.

In fact, Florida investigators say, Golindano was doctoring their applications to make them appear to be employees of two other companies. Then he bought real insurance coverage in their names through Miami-based health insurer AvMed Health Plans, paying the \$2,000 premium and pocketing the \$1,000 difference. AvMed complained to officials after it received \$2.3 million in claims from Golindano's fake employees—nearly all of them pregnant. "It was very slick," says Mazzara. Golindano, who couldn't be reached for comment, was arraigned in a Miami court on Aug.

Data: Insurance Fraud Watch, Dept. of Financial Services, Montana State Auditor, National Healthcare Anti-Fraud Assoc., BusinessWeek

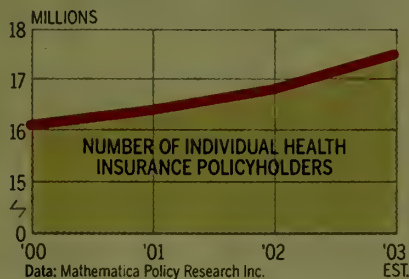
24 and a trial was set for November.

Some operators use regulatory loopholes in some states even after they get shut down in others. In June, Montana State Auditor John Morrison closed down the Montana operations of Health One Inc., a Houston company that charged \$89.95 per month for access to a network of doctors who allegedly offered discount medical and vision care but in reality, says Morrison, provided no discount. But when he asked Health One's home state to shutter all of its operations around the country, Texas couldn't help. Unlike Montana law, Texas insurance law doesn't apply to discount medical plans because they're offering discounts, not insurance, say Texas officials. Many other states have similar rules, the NAIC says, though last month Minnesota ordered Health One to stop selling there. Repeated calls to Health One were not returned.

Still, some headway has been made. The Labor Dept. has opened more than 170 investigations into fraudulent health insurers. On May 24, the Federal Trade Commission sued Pharmacycards.com, which attempted to debit \$10 million from 90,000 consumers' bank accounts without their knowledge. It did so by

RISING TIDE

As costs rise and employer-based health plans are pared back, more people are signing up for individual policies



telling payment-processing companies that they had bought discount drug cards, many under the new Medicare plan that took effect on June 1. Repeated calls to Pharmacycards.com weren't returned.

"A VERY SCARY PLACE"

FLORIDA, WITH ITS huge senior citizen population, has taken the lead in battling health-insurance fraud. Lawmakers last year required all out-of-state health plans to carry a bold warning that consumers forfeit their state protections against fraud and could face premium hikes by

buying them. In January, a new law will require medical discount plans to register with the state. Individual health insurance "is the least regulated market out there and a very scary place to be," says Torre A. Grissom, senior analyst in Florida's Office of Insurance Regulation.

As for the Christensens, Dana's suit against NASE and MEGA is still pending, even as parent UICI set aside \$25 million to settle at least four separate suits alleging that the insurer fraudulently used NASE and other associations to sell its insurance. In May, MEGA said that "without acknowledging fault, liability, or wrongdoing of any kind and subject to satisfaction of certain conditions, it has agreed to settle a substantial number of its pending 'association group' lawsuits." Details remain confidential. "They are taking advantage of people who think they are buying health insurance, but they're not," charges Anthony Stuart, a plaintiffs lawyer representing Christensens. True or not, opportunities for hoodwinking desperate consumers will only grow as Corporate America steadily pares back coverage and more people have to fend for themselves. ■

-By Brian Grow in Atlanta

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Building the New IT Infrastructure

Customers demand more flexibility at lower cost.



If one of Georgia-Pacific's paper mills ran at only 30 percent of capacity, James Dallas would do something about it—and quickly. "We'd be asking ourselves, 'Do we need that mill? How are we going to increase our productivity?'" he says.

Yet when Dallas became vice president and chief information officer in 2002, Georgia-Pacific's distributed servers loped along at just 30 percent of capacity. The



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paper products and chemical company is an all too typical example of a common phenomenon: Customers, consultants and vendors agree that the vast majority of companies' IT infrastructure operate at only 25 to 30 percent of capacity.

Dallas wants to boost utilization of his IT infrastructure to at least 80 percent while giving employees faster and more detailed information about the business. By centralizing management of its IT infrastructure and reducing the number of data centers it runs, Georgia-Pacific is already saving \$90 million a year.

Investing and Saving

The company is one of thousands of organizations that are saving money by investing in new equipment and software that enables them to consolidate data centers and otherwise improve the efficiency of their IT infrastructures. In fact, a survey by Gartner released this year found that "developing an efficient and flexible" IT infrastructure was the top priority of almost 1,000 CIOs.

And their infrastructure focus is reflected in dramatic increases in spending. More than six out of 10 respondents to an AMR Research survey on IT budgets expected to increase their budgets by more than 10 percent, noted AMR Research Analysts Jim Shepherd and Fenella Scott in a recent report.

The spending increases are targeted at specific infrastructure segments, which include servers, personal computers, routers, switches, hubs and other networking gear as well as the operating systems and other platform software required to run an organization. Server shipments, for example, are leaping almost 13 percent this year, according to IDC, after single-digit growth during the past recession (see chart, "Soaring Demand for Servers"). Furthermore, roughly a quarter of the AMR Research survey respondents said their top priority was replacing personal computers.

Many organizations see value in adopting new hardware, software and communications technologies that offer a combination of cost and performance benefits. Among these IT resources are blade servers, the Linux operating system,

Web services and virtualization software, which allows disparate computing devices to appear as a single, logical computing resource to the end user. CIOs also are being driven by new business models such as "utility" computing, where companies buy only the computing horsepower they need, as well as by IT and business professionals working together to redesign the computing systems that drive their businesses.

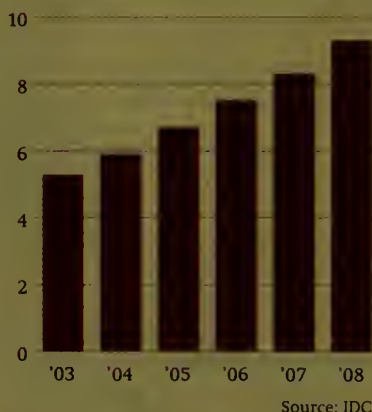
Why Focus on Infrastructure?

Traditionally, an IT infrastructure was created piece by piece for individual business units or to run specific applications. To meet performance and availability levels demanded by business managers, each application typically got enough servers, networks and storage to meet peak demand even if most of that hardware sat idle most of the time, says Yogesh Gupta, chief technology officer at Computer Associates International.

That's because, he says, CIOs themselves rarely could determine how much it cost to provide a given level of application uptime. Rarely, if ever, was the

Soaring Demand for Servers

(yearly worldwide shipments, millions of servers)



overall productivity of the infrastructure measured, adds Georgia-Pacific's Dallas, or was action taken to improve it.

The business downturn of the last few years made customers demand lower costs. But now, "business is picking back

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up," says John Lutz, vice president of sales for IBM's OnDemand business, "and people need to be ready to respond."

A company wants its IT systems to handle a new business process—such as issuing a new type of loan or providing on-line order tracking—in days, not months.



Business users want their IT counterparts to tell them, for example, how much it will cost to provide two-second vs. three-second response time for an application so they can decide how much speed to pay for, says an industry analyst.

In addition to speed and expandability, the new infrastructure must be flexible. That is critical, particularly when companies need to merge their information systems with those of other companies, says Rick Lowrey, executive vice president of the enterprise division at ERP software vendor Deltek Systems. With widespread consolidation in the small to midsize enterprise, "nine times out of 10," he says, customers ask how they will merge systems such as accounts payable and financial reporting if they acquire another company or are acquired.

Indeed, with cost pressures still intense even as the economy improves, customers are demanding IT infrastructures that reduce costs while delivering greater scalability and flexibility. Between 75 and 85 percent of IT budgets are used "to simply maintain existing systems," says Amit Chatterjee, director of Netweaver Product Marketing at SAP AG, leaving only 15 to 25 percent to build new, innovative applications. SAP customers want improved IT infrastructures so they can keep IT spend-

ing level while devoting more dollars to new systems that drive growth, he says.

Analysts agree. Customers are asking not only whether their IT infrastructures can adapt to changing business needs, but whether they can change in ways "that increase the economic value of the infrastructure and whether we can drive costs out of the process" of making those changes, says Scott Lundstrom, chief technology officer at AMR Research.

Blades Slice Hardware Costs

Small, yet powerful rack-mounted blade servers and storage take up less space and require less power and air conditioning than traditional servers. They also are easier to reconfigure because an administrator need only plug and unplug wires on a single rack rather than trace cables among standalone devices. "Blade servers help you reduce the total hardware expenditure, so the net cost of doing what you did before actually goes down," says SAP's Chatterjee.

In this highly scalable and reliable environment, "applications can run across multiple blades and data can get replicated across multiple storage devices," explains Traver Gruen-Kennedy, vice president and chief evangelist at Citrix Systems, and they can be managed easily with robust management software.

Resources

AMR Research Inc.

<http://www.amrresearch.com>

Avaya Inc.

<http://www.avaya.com>

Citrix Systems Inc.

<http://citrix.com>

Deltek Systems Inc.

<http://www.deltek.com>

SAP AG

<http://www.sap.com>

Utility Computing

<http://www.utilitycomputing.com/events/Pages/SanFran/overview.asp>

These servers and special software fulfill the business users' need to obtain critical information regardless of where they are located, the device they are using and the version of an application they are running, says Gruen-Kennedy. New devices ranging from handhelds to mobile phones and even watches that can display data "are coming along so quickly these days you almost don't have time to develop an application for a specific device," he says. By using software that can run applications on servers but transmit only changes in the interface to the user's device, adds Gruen-Kennedy, IT organizations can "develop an application and invest in testing it only once while deploying it everywhere."

Linux and Open Source

Another new infrastructure tool is the combination of low-cost servers and the Linux operating system. Linux is attractive not only because of its low cost but because its open-source model means it is not controlled by a single vendor. It is enhanced and modified by a worldwide network of volunteer developers.

The end-user financial impact of the open-source software movement, however, is one of the most contentious issues in information technology circles today. Is it a financial benefit or a boondoggle?

Studies have shown customers can save on hardware costs, ranging from a factor of three to a factor of 10, when shifting from a proprietary hardware/software combination to an open-source platform, according to Jeff Hawkins, vice president of the Linux business office at Novell, one of the leading Linux vendors. In addition, Hawkins notes that software costs alone can be three to five times lower for an open-source solution.

Microsoft and other software vendors as well as some analysts disagree. They say the total cost of ownership of a Windows-based application can be less than Linux because more functionality is bundled into Windows.

"Discussions with five companies that tracked their total costs indicated Linux was between five and 20 percent

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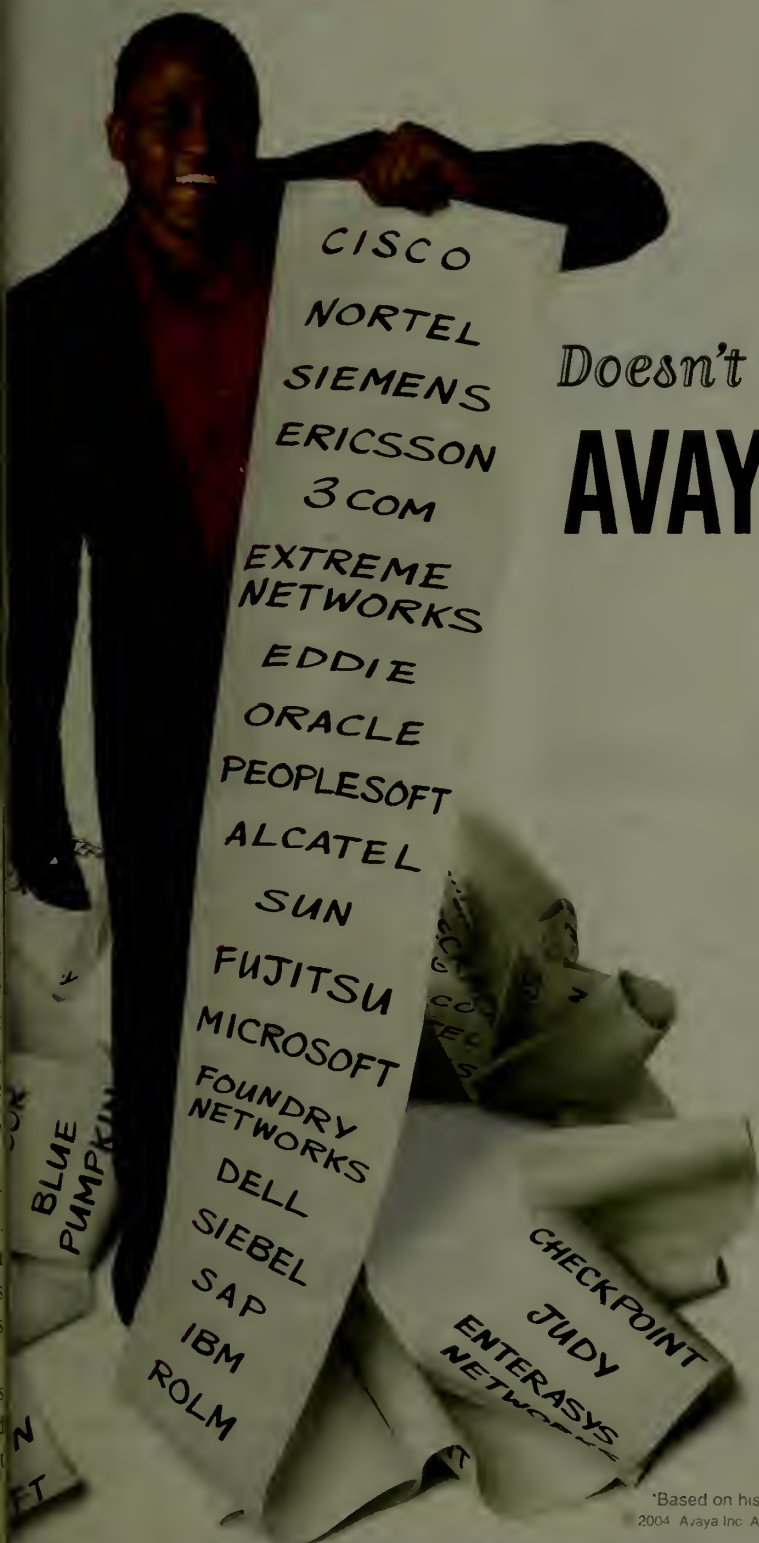
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more expensive than Windows," noted Forrester Research Analysts Julie Giera and Adam Brown in a controversial April 2004 report entitled "The Costs and Risks of Open Source." The analysts did, however, note specific circumstances where a Linux-based implementation was less expensive.

As IT managers and techies in general became comfortable with Linux as a reliable operating system for non-critical tasks, they began to move it into more important roles. Specifically, the Linux operating system and the Apache Web server application software have become a popular duet in many organizations.

With widespread consolidation of small to midsize companies, almost all customers ask vendors how they can merge systems.



Typically, cost comparisons are extremely dependent on specific circumstances. C-level executives considering an IT recommendation to shift to an open-source approach or facing a decision to base a new application on an open-source platform need to dig deep to fully understand the ramifications.

And those ramifications are not just financial. While the "real" cost of Linux vs. Windows and Unix is somewhat debatable, even open-source zealots acknowledge that their hardware and software platform isn't ready to take on the biggest and most challenging IT tasks. The scalability, performance and other aspects of the open-source products are not quite up to the levels of more established operating system platforms such as Windows running on large servers.

Most organizations are experimenting with Linux and low-cost servers to determine the benefits and disadvantages. "Linux initially was adopted at the periphery of the network," Hawkins notes. "It was used in less-critical business functions, areas where it was relatively risk-free for organizations to try it. In the beginning, there was a lot of experimentation."

In the past two years many leading applications vendors such as SAP have begun offering Linux versions of their mission-critical software. Along with other open-source packages such as the MySQL database software, IT departments now have a variety of choices that may or may not offer significant cost benefits.

New Software Approaches

Several new approaches to computing promise to further enhance the efficiency of an organization's infrastructure. They are known as a services-oriented architecture, virtualization and utility computing.

A services-oriented architecture is one of the most talked about possible solutions to an inflexible infrastructure. It is a way of writing and deploying software that provides common functions such as printing or order entry across different applications and different computing platforms. This makes it easier to shift processing loads onto the most cost-effective hardware as needed and to change information systems as business needs change.

Virtualization treats multiple hardware and software components as if they were a single, "virtual" resource. A relat-

ed capability is partitioning, which divides a single server into multiple "virtual" machines running different applications or even different operating systems. "People don't want to have a dedicated server for every application they support [or] a dedicated server for every instance of every application," says AMR's Lundstrom. Health insurer Cigna, for example, is using software-partitioning capabilities from both IBM and Microsoft, says Chief Technology Officer Marcus Shipley.

Utility computing—the ability to buy computing power on demand, much like electricity or water—already is working for Mobil Travel Guide. When the company began re-architecting its Web site in 2002 from a simple informational gateway to a site that processes transactions for business partners, it considered traditional outsourcing, where the customer owns the hardware and the outsourcer manages it at its own sites. But IBM offered a new product called Linux Virtual Services, where "we buy the computing and network capabilities as a utility" hosted on an IBM Linux mainframe, says Paul Mercurio, senior vice president and CIO.

Because Mobil Travel Guide orders the amount of computing power it will need from IBM each month, the Web site can grow from its current 1,000 visitors per month to tens of millions without increasing its two-person operations staff. "If you own the hardware, you've paid for the capacity you will require on the peak day and you're paying for it every day of the year," he says. Because Mercurio buys computing power as needed, he avoids capital spending and "can be opportunistic" in forging partnerships that would drive more volume to his site, confident the mainframe can handle almost any surge in traffic.

New Role for Telecom

When companies look at how much of their enterprise data systems' throughput and disk space goes unused, they start exploring better ways to use those resources. Over the last two years a

popular C-level answer has been telecom.

Although tempting, many companies have quickly discovered that turning voice into data is not as straightforward as adding a new database application. The technology works well, but when voice-over-IP (VoIP) meets the data infrastructure it's not always immediate, clear calling.

First, there are the ever-present interoperability issues with existing hardware and software that were not designed with VoIP in mind. And the few elements that were designed for voice traffic are more than likely highly proprietary and won't work with competing systems.

Second, companies quickly discover that multimedia content cannot be handled like traditional data content. Voice traffic takes up a lot more room than data, and "voice is extremely less forgiving," says Deborah Kline, an Avaya senior manager. The way a network typically handles data—with packet assembly and prioritization—simply won't work with voice. A 60-second delay in an e-mail transmission is barely noticeable, but a two-second delay in a telephone call is extremely obvious.

"When you put voice on your data network, you need to do a full network assessment," Kline says. "You can't have a cavalier attitude that 'my network is ready for voice.'"

But Kline says that those infrastructure hurdles are worth working out because the VoIP capabilities are so vast.

Although VoIP arguments tend to dwell on the significant potential long-distance cost savings, Kline says its capabilities make it worthwhile.

For example, many companies today have building-specific telephone systems that prevent calls from being switched from one building to another. Toll-free calls coming into the wrong building must dial in again.

Think Big, Start Small

Some CIOs may choose to—and can afford to—be more proactive than others in moving toward a services-oriented architecture, says SAP's Chatterjee, "taking a business plan from a CEO and, as the CIO, identifying" where services-oriented platforms could play a role.

Others who are more conservative will start to reduce costs through, for example, a server consolidation process, he says, and then adopt services-oriented software or platforms to address "pain points" as they arise in the business, with an eye toward how those individual applications or platforms will eventually work together.

Cigna's Shipley suggests first "identifying non-core, non-mission-critical processing, doing some testing and getting some experience with the technology." Then, he says, "If you have replacement plans, you want to replace those [systems] with infrastructure that offers this type of flexibility."

Indeed, IT infrastructure architects need to know where they want to end up. But they must work toward that goal through individual projects, each of which delivers a return on investment. Cigna, for instance, is 18 months into a drive to create an efficient and flexible infrastructure for the company and is on track to reduce its server count 25 percent by early next year.

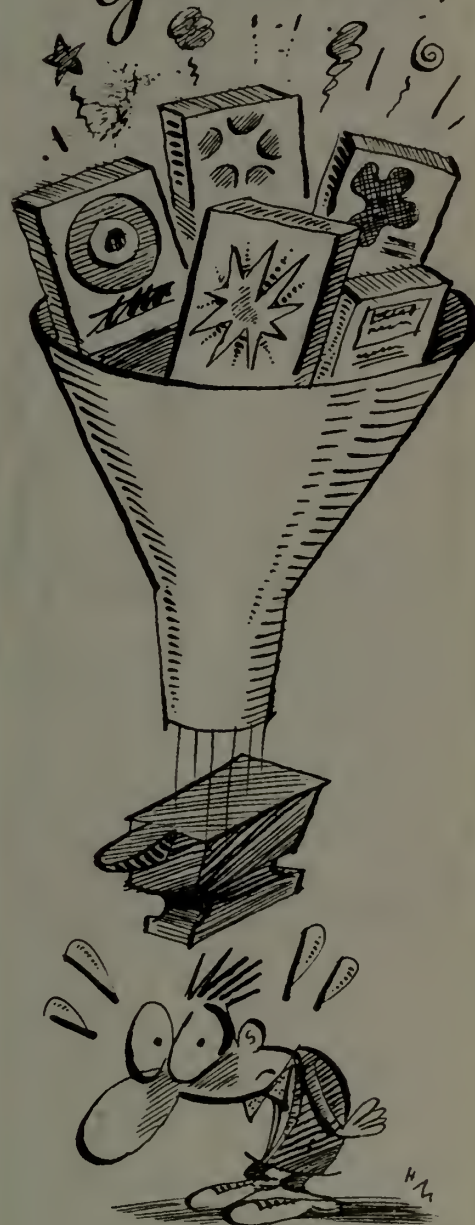
"It takes some forethought and planning, but this technology is real," Shipley says. "The onus is on the IT community to figure out how to turn this technology—this new IT infrastructure—into a viable platform for delivering business solutions more flexibly." ■

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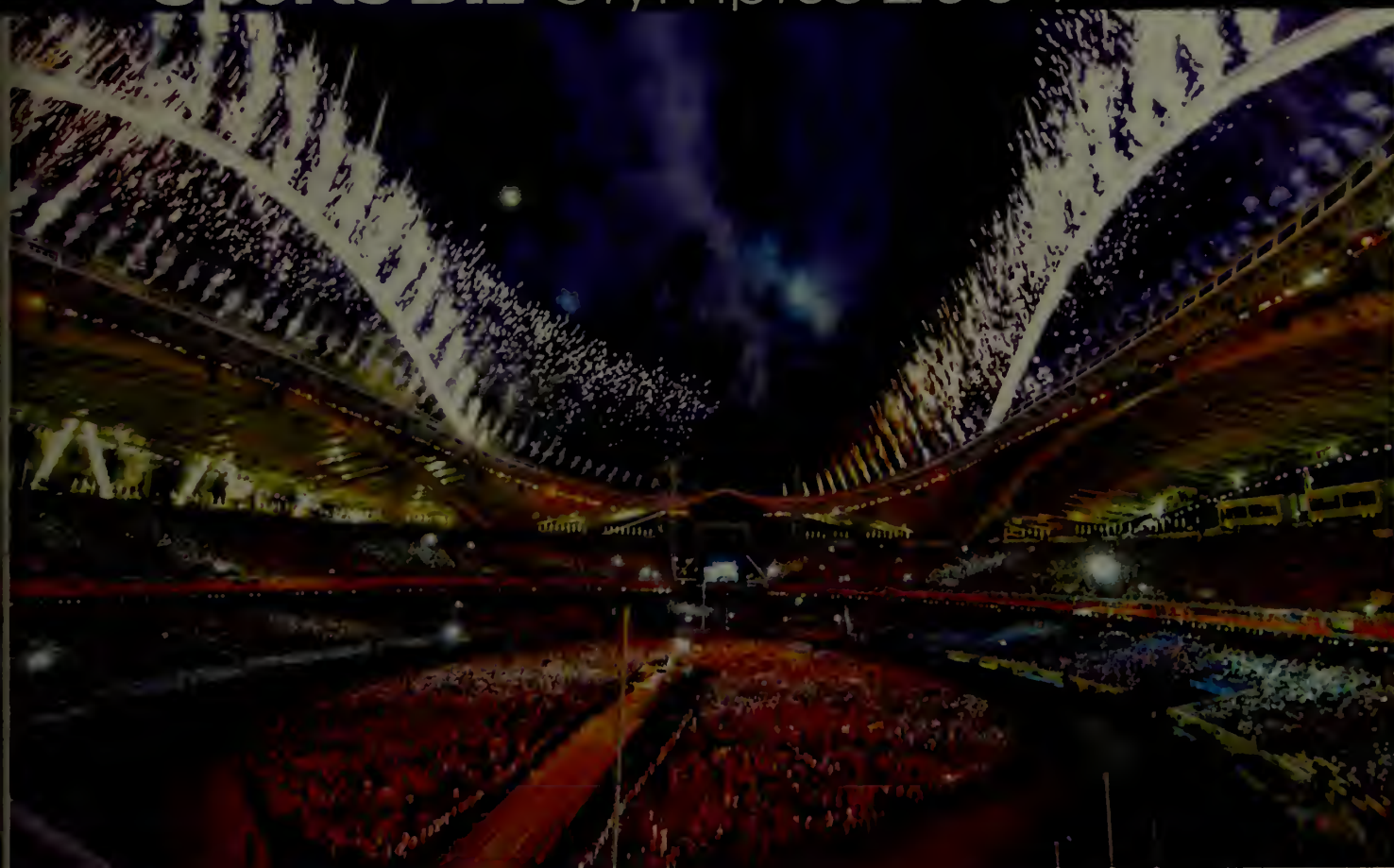
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A Big Fat Greek Triumph

The Games' success should help Greece's economic and cultural standing soar

AS A GREEK, NICOLAS Nicola, Eastman Kodak Co.'s sales manager in Greece, was sure his country would be ready for the Olympics. Pretty sure, anyway. Nicola admits feeling nervous as he drove by the marathon route near Athens a few weeks before the event and saw workers frantically laying down pavement. There was plenty at stake for both Nicola's homeland and his employer: Kodak is a major sponsor. "For the sponsorship to be maximized, the showcase has to be ready," says Nicola.

Happily, it was. Greece defied the skeptics and the "My Big Fat Greek

Olympics" jokes and presented Games that were worthy, even brilliant. Now, Nicola and 11 million compatriots are swelling with pride. The Games made Greece a "full-fledged member of the European club, finally," says Nicola. "What they have done for the national self-image is invaluable."

That's exactly the payoff Greece hoped for in return for its massive investment, which could hit \$9 billion, or 5% of gross domestic product. Aside from an infrastructure makeover, including new highways, subways, and even beaches, Greece has polished its self-esteem as well as its world reputation. Forget stereotypes about disorganized Greeks. Security preparations

proved adequate, and even the fussy Germans were impressed by touches such as overnight laundry service for athletes in the Olympic Village. "I have to say it all went a thousand times better than expected," says Stefan Forster, a former rower and member of the German Olympic Committee who accompanied his team to Athens.

BANG-UP JOB
The closing ceremonies on Aug. 29

WINNERS WITHOUT MEDALS

THE RESULTS should include more foreign investment and higher living standards for Greece, still one of the European Union's poorer members. There already has been a boom in entrepreneurship as small businesses spiffed up their stores and bought new cars and equipment. At the least, 4 billion TV viewers have registered that Greece gets a lot of sunshine, and some will no doubt decide to visit. "If tourism doesn't skyrocket, we are doing something wrong," says Stephanos Vrakas, client coordinator at the exclusive Grand Resort Lagonissi near Athens.

There are other reasons to feel good about these Olympics. Ticket sales were tepid, especially compared with Sydney in 2000, but sponsors were thrilled with viewership, which was up more than 10% over the Sydney Games in 2000. NBC offered a record 1,200 hours of coverage

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around the clock on an unprecedented six network and cable channels. Surfers on the Web were swept up: NBCOlympics.com attracted 12.2 million visitors, a 230% increase over Internet traffic for the Sydney games. Says Dick Ebersol, chairman of NBC Universal Sports & Olympics: "By having so much coverage available throughout the day, a new generation of Olympics junkies was born this summer."

Some fans surprised themselves by learning to love such offbeat sports as badminton and handball. "These were the best Games overall from adidas' perspective," says Erich Stamminger, head of global marketing for German sportswear maker adidas-Salomon. The Olympics don't move goods as briskly as an international soccer tourney, he says, but by outfitting less popular sports such as wrestling, adidas hoped to build its image as a maker of equipment for serious athletes. For its part, Coca-Cola Co. praises the Greeks' handling of the torch relay, turning it into a global event that spurred publicity. "We felt that was a big success," says Scott McCune, Coke's vice-president for sports entertainment and licensing.

The elaborate security preparations, costing \$1.2 billion and including a \$300 million communications and surveillance system, apparently deterred terrorists. "At some points we felt like the Maytag repairman, which is a great way to feel if you're in this business," says Robert N. Sikellis, managing director of Vance International/Decision Strategies, based in Oakton, Va., which provided security services and consulting to Olympics organizers and sponsors.

Indirectly, the Games even gave impetus to economic and political reform in Greece. The success of the Olympics provides a political bounce for the center-right government led by Kostas Karamanlis, who in March ended 23 years of nearly unbroken rule by the center-left.

Now he has the political capital to carry out reforms such as cutting bureaucracy that stymies new business creation and revamping bankruptcy law to encourage more risk-taking.

UNDERDOGS

MOST IMPORTANT, Athens delivered on its promise to bring the Games closer to their roots. True, there was something incongruous about wreaths of olive branches on the heads of beach volleyball medalists. But the Games had a human scale and feel and they represent progress toward keeping the Olympics from becoming unmanageably large. "The Games are not just about commerce. They need to be fun," says Jochen Zeitz, CEO of German sportswear maker Puma, which sponsored the Jamaican Olympic team.

So what's not to like? Well, Olympics spending has already pushed Greece's budget deficit above EU limits, and sectors of the economy such as construction may cool off fast. Athens could be forced to raise taxes, which might hurt consumption and lead to slower growth after an estimated 3.8% in 2004. "Growth above 3% is good, but to catch up with the rest of Europe we need to grow much faster," says Paul Mylonas, general manager for strategy and economic research at the National Bank of Greece.

But Athens has struck a blow for all the other underdog countries that may want to

host the Summer Games someday. That won't happen for more than a decade. Beijing will host in 2008, and 2012 will go to one of five wealthy-nation cities in contention, with Paris the apparent front-runner. For 2016, there is already talk of bids from the likes of Thailand, Chile, and the Netherlands, according to GamesBids.com, which follows the Olympics process. See you at the decathlon in Bangkok? After Athens, it's not out of the question. ■

—By Jack Ewing in Frankfurt and Kate Carlisle in Athens

Olympics Scoreboard

What went right and wrong in Athens

PLUSES

- Greeks shed reputation for being disorganized
- New infrastructure means Athens works better, looks nicer
- Surge in national pride should boost confidence and help economy
- Feared terrorist attack never materialized
- Smaller countries more likely to qualify as Olympic hosts in future

MINUSES

- Risk of slowdown as construction boom ends
- Massive \$12 billion cost could negate some of the economic benefits
- Doping controversies

Data: BusinessWeek

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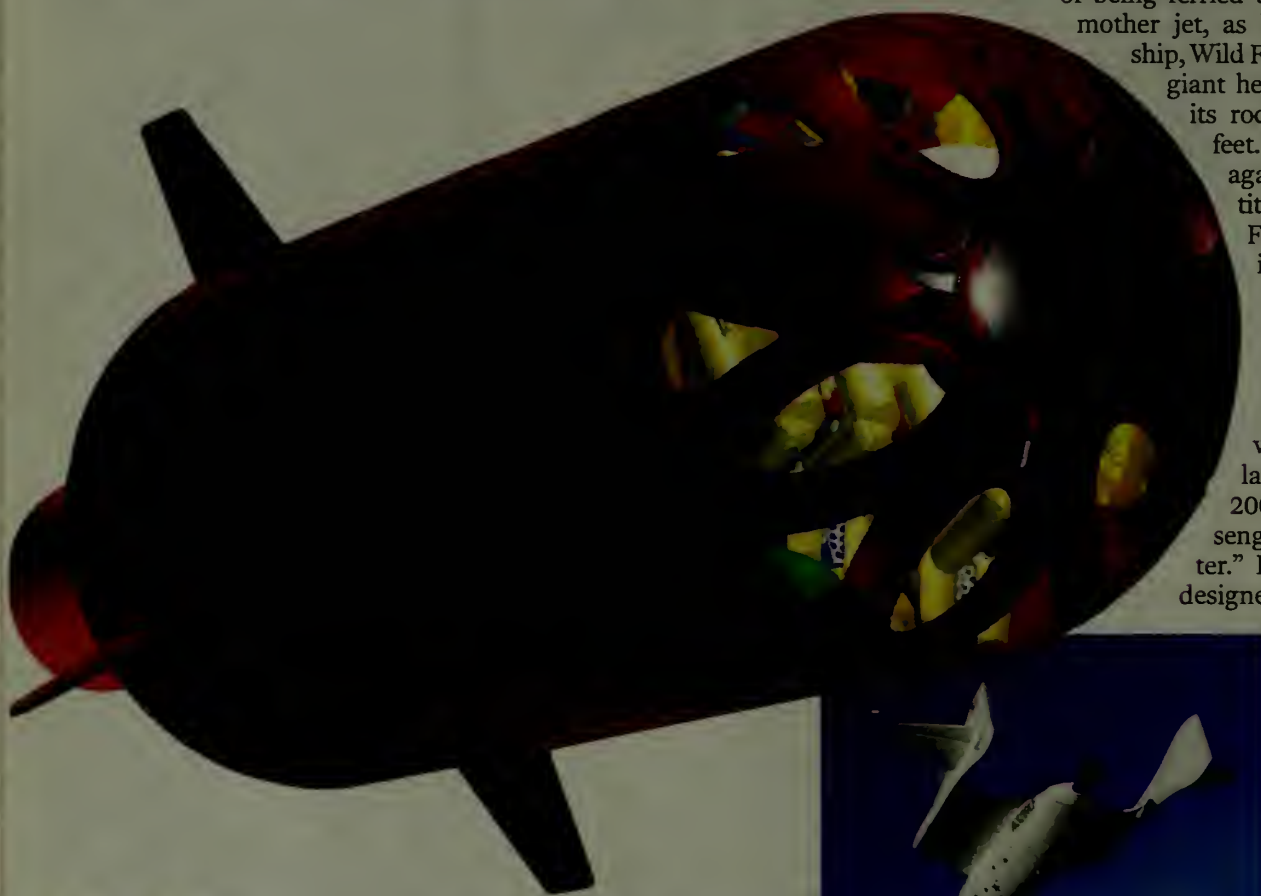
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Gentlemen, Start Your Rockets

The race for space is heating up as private outfits head for the launchpad



HOPING TO PROMOTE transatlantic tourism, French-born New York hotelier Raymond Orteig in 1919 pledged a prize of \$25,000—worth about \$750,000 today—for the first nonstop flight between New York and France. In the 1920s, nine teams scrambled to try to win that prize. Then Charles A. Lindbergh piloted the Spirit of St. Louis across the Atlantic in May, 1927, and commercial airlines soon followed.

About 10 years ago, entrepreneur Peter H. Diamandis figured a prize might have the same effect on manned space travel. So he set up the X Prize Foundation and coaxed wealthy contributors to offer a

purse of \$10 million to the first privately funded, three-person spacecraft to fly into suborbital space twice within a two-week period. On June 21, the world wit-

nessed the lead contender: SpaceShipOne, designed by aeronautics engineer Elbert L. "Burt" Rutan with backing from billionaire Paul G. Allen, soared up 62 miles to the edge of the earth's atmosphere.

At the end of this month, the Rutan-Allen partnership will make a real run for the prize. The first flight is slated for Sept. 29, and if it comes off without a hitch, Rutan says he might climb into a passenger

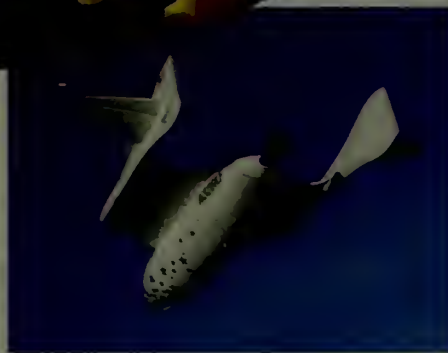
seat for the second launch on Oct. 4. But by then one of the two dozen other X Prize competitors will be close on Rutan's heels. A Toronto group called the da Vinci Project plans the first launch of its Wild Fire rocket on Oct. 2 from the remote airport in Kindersley, Sask. It's a goal that da Vinci head Brian J. Feeney, now 45, has been working toward full time since the week the X Prize was announced in 1996.

STIFF COMPETITION

LIKE SPACESHIPONE, which was built by Scaled Composites LLC, Wild Fire will ignite its engine high in the sky. But instead of being ferried up to 50,000 feet by a mother jet, as happens with Rutan's ship, Wild Fire will float up under a giant helium balloon, then fire its rocket at around 70,000 feet. "We know we're up against some stiff competition from Burt," says Feeney, "but I'm not giving him any ground." Indeed, Feeney already has his eye on the next milestone: commercial space tourism. "We have an eight-person vehicle we want to fly late next year or early in 2006—and 12 paying passengers might be even better." Rutan, meanwhile, has designed a stretch version of

SpaceShipOne that can accommodate six or more people.

Waiting in the wings is Canadian Arrow in London, Ont. Before yearend the team hopes to launch its rocket based on the V-2 designed 60 years ago by Nazi Germany. Canadian Arrow head Geoffrey T. Sheerin, 41, is looking for someone who will cough up \$1 million or \$2



BLASTOFF Canada's Wild Fire, top, will be lofted into firing position by helium balloon, while SpaceShipOne is launched from a mother jet

million "to put a logo the rocket."

Two other X Prize contenders recently suffered minor setbacks with tests of unmanned rockets. On Aug. 8, the Rubicon built by Space Transport Corp. in Forks, Wash., dove into the Pacific Ocean shortly after launch. A day earlier, the Black Armadillo rocket, developed by Armadillo Aerospace, climbed to only 600 feet before crashing back to earth. On its Web

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site, the Mesquite (Tex.) company is now hawking pieces of the wreckage—"Armadillo droppings"—for \$125.

So far, Armadillo founder John Carmack has laid out about \$1.5 million from the fortune he amassed developing video games such as *Doom*. "We'll be flying [another test rocket] in a month or so, but we're pretty much out of the running for the X Prize," he admits. Carmack says his long-range goal is to rake in another fortune from space tourism.

SPACE TOURISTS

NOW THAT RUTAN and Allen have shown that suborbital hops are possible for what amounts to pin money at NASA, the roadblock to space tourism isn't technology. It's politics. Even if Carmack had a rocket that could whisk tourists into space, he notes, "there is no commercial spaceport in the U.S. licensed for vertical rocket launches from ground level." Until Congress enacts legislation that clears the way for such launches, his only alternative would be to pay nearly \$200,000 per launch to use White Sands Missile Range in New Mexico. That would drastically hike ticket prices.

The big roadblock now isn't tech but politics

Before Rutan's feat, says Sheerin of Canadian Arrow, "if you suggested building a space-tourist vehicle, you couldn't find the capital, because culturally we've been taught you can't do that." But since June 21, there has been a sea change: "The business community is now starting to look hard at suborbital tourism to make sure they don't miss an opportunity," Sheerin says.

That's just the result that Diamandis envisioned. He grew up with the expectation that his generation would regularly venture into space. Hooked on space since he watched Apollo 11 land on the moon in 1969 at age 9, he even earned an M.D. in hopes that the credential would help get him on missions as an astronaut. He gave up that ambition, and medicine, when he realized "the government wasn't going to get us into space routinely," he recalls.

For that, he says, "we need a mass market—the same kind that gives us low-cost airlines like JetBlue." The X Prize just might hasten liftoff for affordable, everyday space travel. ■

—By Otis Port in New York

Double Danger For Big Tobacco

A Justice suit and a push for FDA oversight have cigarette makers gasping

THE CLAIM IS BREATHTAKING. On Sept. 21 the U.S. Justice Dept. is scheduled to make opening arguments in a civil Racketeer-Influenced & Corrupt Organizations Act (RICO) lawsuit asserting that the nation's biggest cigarette companies have engaged in an illegal conspiracy since 1953. The government is seeking disgorgement of a brow-raising \$280 billion—almost the six defendant companies' entire profits during the five-decade period.

Big Tobacco has faced many legal challenges through the years but never one this daunting. And it comes at the exact same moment as a bill now in Congress proposing to give the Food & Drug Administration the power to regulate the manufacturing and contents of cigarettes—something the industry has energetically tried to avoid for most of its recent history. The measure passed the Senate by a wide margin in July. Although it faces skeptics in the House, it could very well reach a vote by October.

In the old days, the companies could a





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*Toyota components and vehicles are made using many U.S. sourced parts. **Direct U.S. employment: 31,040 jobs as of 12/03. ©2004

least draw strength from one another. Cigarette makers stood shoulder to shoulder against all attacks. But the old fortress mentality has dissipated. While the Justice suit could be devastating for big players such as Altria, Reynolds American, and Liggett, it may be a blessing for upstarts that aren't named in the suit, including Commonwealth Brands Inc. and General Tobacco. FDA regulation, meanwhile, is backed by No. 1 cigarette maker Altria Group Inc.—but opposed by nearly every other company in the business. “This is not only controversial because it’s about tobacco,” says Merrill Lynch & Co. tobacco analyst Martin Feldman. “It’s controversial because you have the industry split.”

As the heat builds for tobacco companies, the market itself has never been tougher. Because of a steady climb in state and local excise taxes and the high cost of the Master Settlement Agreement (MSA) signed by the largest companies in 1998 to end lawsuits filed by 46 states, the price of cigarettes has soared—yet profits are eroding. Feldman notes that the average price of a pack of Marlboros at the time the MSA was signed was \$1.88. Today, it’s \$3.41. Although key brand Marlboro has actually increased its market share, to 39.5%, Altria’s earnings are down. Its U.S. tobacco business, Philip Morris USA Inc., had an EBITA operating profit of \$5.76 billion three years ago (chart), Feldman notes. By last year, that had dropped to \$4.2 billion. R.J. Reynolds, now part of Reynolds American Inc., saw an even sharper drop from \$1.3 billion to \$722 million, and others are down too.

LOW-COST UPSTARTS

MEANWHILE, THE traditional industry leaders are under attack by a host of fast-growing low-cost manufacturers like Star Tobacco and Dosal Tobacco Corp. These companies aren’t part of the MSA, which adds up to 50¢ for each pack of cigarettes. Ronald J. Bernstein, president and CEO of Liggett Group, calls the overall level of competition “almost frantic.”

Altria, Reynolds, and the other major to-



BLOWING SMOKE
Justice says the industry downplayed cancer risks

lines 50 years of industry attempts to cloud the true harm of smoking. The industry’s alleged goal: to “preserve and enhance...profits by maximizing the numbers of smokers.” The government contends, too, that while the industry was arguing that there was no proof that cigarettes cause cancer, it had already documented known carcinogens in its products. Prosecutors are asking for profit disgorgement and a new regulatory scheme that would bring many of the re-

bacco manufacturers could hardly stand a Justice victory. The feds argue that the industry operated as an illegal enterprise starting with a December, 1953, meeting in the Plaza Hotel in New York. During this get-together, the government claims, five tobacco CEOs hatched a plan to fund scientific research and a publicity campaign to battle rising concerns about cancer.

In its 1,000-page finding of fact, Justice outlines the industry’s strategy to cloud the true harm of smoking. The industry’s alleged goal: to “preserve and enhance...profits by maximizing the numbers of smokers.” The government contends, too, that while the industry was arguing that there was no proof that cigarettes cause cancer, it had already documented known carcinogens in its products. Prosecutors are asking for profit disgorgement and a new regulatory scheme that would bring many of the re-

to limit the massive disgorgement sought, Altria stock dropped to a six-month low of \$44.95 a share.

It may be a sign of how out of favor the industry is that even the free-market Bush Administration has failed to slow the case—despite the fact that it was started by the Clinton White House and has cost \$135 million to prepare. Why didn’t W’s troops kill the lawsuit? Some tobacco execs and analysts speculate that the political costs of dropping the suit would have been too high.

GOOD PUBLICITY?

INDEED, ALTHOUGH ALTRIA executives deny it, some observers think one reason the company is backing FDA regulation to defuse future judicial and judicial anger against the industry. The legislation would give the FDA oversight of the manufacturing of cigarettes and would enlarge the health warnings they carry. It would also provide FDA regulation of any new products that claim to lower the harm of cigarette smoking. And the new standards would apply to all manufacturers, small and large.

Altria’s rivals worry the proposed marketing restrictions would hinder them

from gaining market share against the dominant leader. They also fear that the fine print of the bill’s provision for FDA review of safe cigarettes would specifically help Philip Morris’ ongoing efforts to make a product aimed at reducing exposure to harmful substances in cigarettes. “If you can partner with govern-

ment to kill your competition off, then that’s a good deal,” says Tommy J. Payne, rival Reynolds American’s executive vice president of external relations.

Supporting the bill is certainly a big shift for Altria, which spearheaded the industry’s rigid opposition to FDA oversight in the late 1990s. Now the company hopes an FDA regime might help usher in an era of better public relations. “One of the basic things we’ve been trying to say for the last seven to eight years is it doesn’t always have to be us against everybody else,” says Steven C. Parrish, Altria’s senior vice-president of corporate affairs. So far, though, it looks as if the cigarette manufacturer and its rivals are more embattled than ever. ■

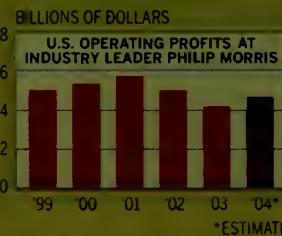
—By Nanette Byrnes in New York, with John Carey in Washington

SLOW BURN

Competition is tougher...



...and profits are lower



strictions the companies agreed to under the MSA to a national level.

Tobacco companies have denied any conspiracy and argue that the government’s aggressive application of the RICO statute in this case won’t hold up. To win its case, Justice has to prove that the past behavior it describes is likely to continue. Yet since the MSA, industry lawyers say, company behavior has improved. “Cigarettes today are sold very differently than they were in the past,” says Altria general counsel William Ohlemeyer.

While some of the industry’s legal arguments appear to be strong, ordinary rules do not apply to such an unpopular defendant. Justice has won several, though not all, pretrial motions, and investors have reacted badly. On May 24, when the judge hearing the suit refused

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THE SYMBOLISM COULDN'T HAVE been more stark: The son trying to overthrow the father. Seventy-year-old AFL-CIO President John J. Sweeney had come to San Francisco in June to give a pep talk to 3,000 members of the Service Employees International Union (SEIU), a union of public-sector, health-care, and janitorial workers he had run before becoming labor's chief honcho in 1995. But instead of a rousing homecoming reception, his successor and former protégé, 53-year-old SEIU President Andrew L. Stern, let rip a razor-sharp swipe at Sweeney's largely failed struggle to rejuvenate the labor movement over the past nine years.

Stern's message: Labor remains in a death spiral, and its house needs a top-to-bottom overhaul if it's ever going to revive. The AFL-CIO, he charged, has become an antiquated structure that "divides workers' strength." When the SEIU's own policies and traditions hindered its expansion, Stern reminded his audience, he swept them aside. Barring drastic action, he told his delegates, the 1.6-million-member SEIU should break away and start a new federation. Change "is so long overdue that we either transform the AFL-CIO—or build something stronger," he proclaimed.

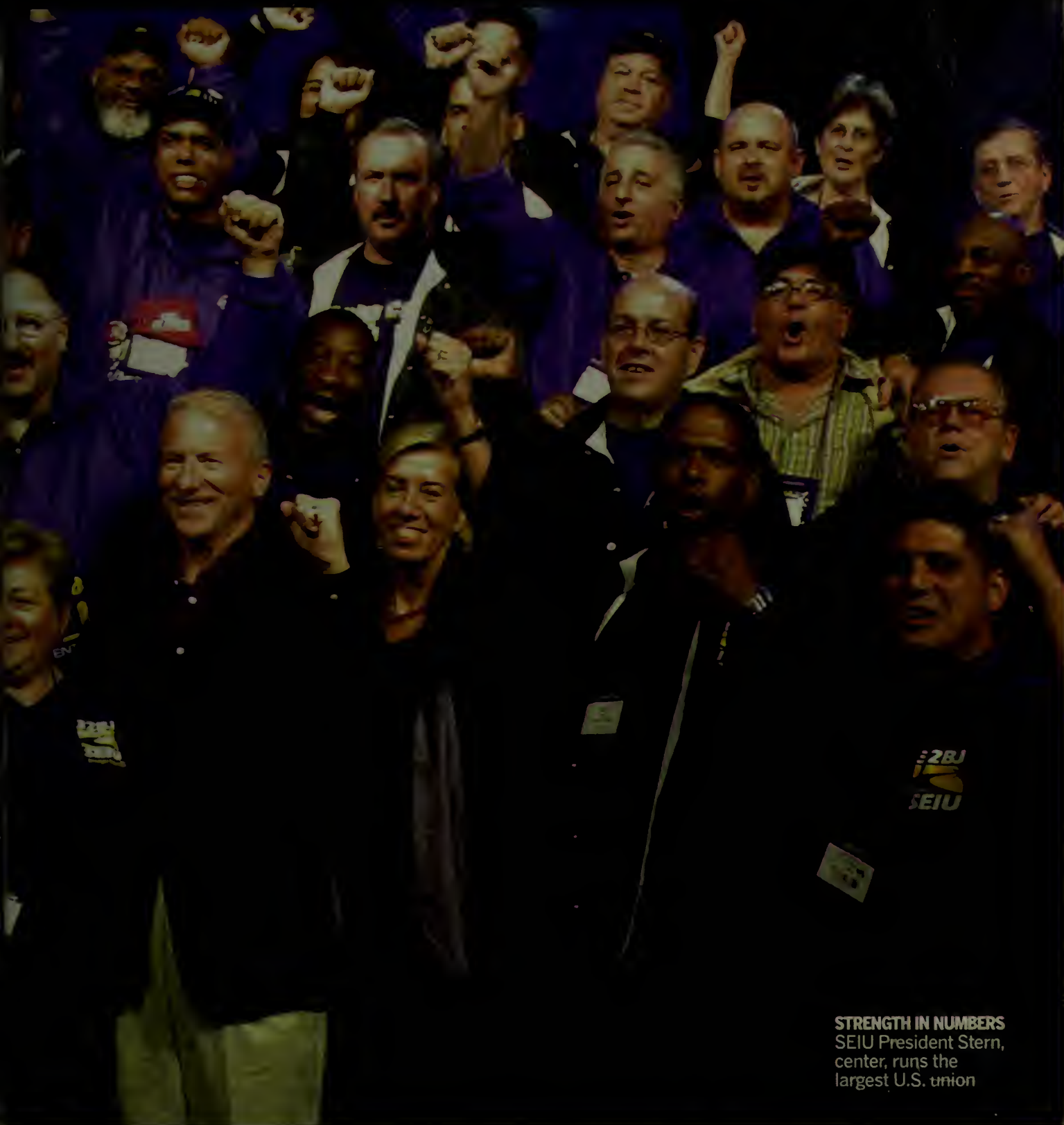
In the clubby world of organized labor, these harsh public words were an open declaration of war—one that has been roiling the nation's labor leaders ever since. It comes after several years of increasingly vocal criticism by Stern and four fellow

ANDY STERN WANTS TO RADICALLY RETOOL THE U.S. LABOR MOVEMENT. BUT FIRST HE MUST WIN OVER SOME POWERFUL UNION LEADERS

BY AARON BERNSTEIN



CAN THIS MAN



STRENGTH IN NUMBERS
SEIU President Stern,
center, runs the
largest U.S. union

SAVE LABOR?

RANDY SANTOS



Change in the AFL-CIO “is so long overdue that we either transform [it]—or build something stronger.” —ANDY STERN, SEIU PRESIDENT

union leaders who have been agitating for a fundamental re-vamping of labor. The five men, including the heads of the carpenters, the laborers, and the needletrades and hotel-workers' unions (table), which merged this summer, formed the New Unity Partnership (NUP) in 2003 to showcase what they want to do.

Now NUP, led by Stern, is accelerating its campaign, hoping to shake up the entire 16 million-member labor movement. The goal: to get unions growing again in an economy in which their membership has fallen to just 13% of the workforce. Stern, who leads by far the largest and fastest-growing U.S. union, is aiming high, planning to force the federation to confront its malaise with constitutional changes when the AFL-CIO meets next July for its quadrennial convention. He and fellow NUPsters haven't worked out the details, but they have been hashing out the broad

themes for a year. The central idea is to slash the AFL-CIO's 60 unions to 15 or 20 powerful mega-unions—and get those to focus on building what they call membership density, or share of the labor market, in specific industries, thereby giving unions more clout to lift wages.

Capturing the leadership is also in the plan: John W. Wilhelm, former hotel-workers president and NUPster, is likely to run against Sweeney, who's up for reelection next year. But the group faces a tough battle. Some labor leaders say they see Stern as power-hungry and arrogant, and he has made enemies by poaching public-sector workers claimed by Gerald W. McEntee, president of the 1.4-million-member American Federation of State, County, and Municipal Employees (AFSCME). In a sign of how hard-fought the contest could be, United Brotherhood of

Carpenters President Douglas J. McCarron, who quit the AFL-CIO in disgust over Sweeney's policies in 2001, swallowed his pride and told the federation chief on Aug. 24 that he would rejoin the AFL-CIO. That would allow him to cast his 520,000-member vote for Wilhelm next summer.

Right now the entire labor movement is obsessed with putting a Democrat back in the White House. But come Nov. 3, Stern and his NUP pals say they'll refocus on reversing labor's decline. “What we're doing in the labor movement isn't working. There has to be dramatic change,” says Wilhelm, who's now No. 2 in the merged needletrades and hotel union, called UNITE/HERE. “After the [November] elections we're going to have a full and vigorous debate about what to do.”

Nothing less than a deep sense of desperation about the fate of organized labor drives Stern & Co. The forces of globalization that began pounding labor's manufacturing strongholds in the late 1970s have intensified in recent years as offshore production has exploded. Membership has slid steadily in service industries, too. In everything from retailing to health care to office work, deregulation heightened competition, and cheap immigrant labor have forced employers into a ceaseless struggle to keep down costs including wages and benefits.

The so-called Wal-Martization of the economy has fueled the trend: Many companies feel pressure to seek out the lowest costs, even if it means paying skimpy wages. American paychecks have slid again after the gains of the 1990s; more employees are losing company-paid

How Stern Wants to Remake The House of Labor

Service Employees President Andy Stern and four other union leaders want sweeping changes in the way the AFL-CIO and its member unions are run. While they're still formalizing their plans, they have been discussing ideas such as:

CENTRALIZED AFL-CIO Alter the AFL-CIO's constitution to allow for a more powerful executive body, so it can force unions to change more rapidly

A FEW MEGA-UNIONS Prod dozens of small unions to merge to create 15 or 20 powerful million-plus-member ones, down from more than 60 today

INDUSTRYWIDE BARGAINING Get unions to focus on specific industries to boost their bargaining clout so they can lift wages and benefits across the board

MASTER LABOR CONTRACTS Create industrywide labor pacts to maintain uniform wage levels across companies

JOINT MEMBERSHIP DRIVES Multiply labor's strength by mounting multi-union recruitment drives against giant employers such as Wal-Mart

Data: BusinessWeek



TERRY O'SULLIVAN
Laborers'
International head



JOHN WILHELM
No. 2 at
UNITE/HERE



DOUG MCCARRON
Carpenters'
president



BRUCE RAYNOR
President of
UNITE/HERE



RITA CORTES

The Secaucus (N.J.) janitor has doubled her salary since she joined the SEIU three years ago after a blitz recruitment campaign

unions as more suited to an industrial age, with often-rigid work rules and little to offer in a high-tech, knowledge-based economy. Certainly, unions' ability to protect pay and benefits has diminished drastically, as seen in the huge pension losses for unionized workers in steel and airlines. "I don't believe that secret-ballot union elections have been corrupted by management. The problem is that unions have lost their relevance to the American workplace," says Andrew M. Kramer, a labor law partner at Jones Day who represents large employers such as General Motors Corp.

Still, Stern's drive to kick-start labor comes from watching the SEIU and a few other unions succeed in becoming relevant to workers despite all the obstacles. Some observers see him as trying to play the role of labor giant John L. Lewis, who helped create the Congress of Industrial Organizations in the 1930s when the craft-oriented American Federation of Labor he belonged to seemed incapable of aiding low-skilled factory workers. Lewis fanned out hundreds of organizers from the then-powerful mineworkers union, which he headed for 40 years, to help form unions in autos, steel, and telecommunications—largely because he felt that his group couldn't survive on its own.

Stern has been taking analogous steps, laying the groundwork for a parallel, CIO-style federation should the campaign to transform the AFL-CIO fail to take hold. The SEIU recently ponied up \$1 million to help the United Food & Commercial Workers tackle Wal-Mart Stores Inc. He's building separate political muscle, shelling out an astonishing \$65 million to elect John Kerry and make the political atmosphere more receptive to a labor comeback. Stern helped found the Democratic Party's most successful 527 political committee, America Coming Together, which is headed by former AFL-CIO Political Director Steve Rosenthal (a close personal friend with whom he has shared a New Jersey beach house for 25 years).

The SEIU also set up a political network aimed at nonunion Americans called PurpleOcean.org, modeled after a similar effort the AFL-CIO launched last year. Stern told his convention: "We know that even if we build strength in our industries, no one union, including SEIU, can succeed as an isolated island of strength in a nonunion sea. As the largest union, it is our job to help rebuild U.S. labor's strength."

An ambitious, impatient man with the lean frame of a regular runner, Stern has turned the SEIU into a whirlwind of activity that he thinks others could emulate—if they're willing to change how they operate. The SEIU nearly doubled in size, to 1.1 million, during Sweeney's tenure there, in part due to Stern's role as recruitment chief (a job Sweeney tapped him for in friendlier days). Then Stern took the reins and cracked the whip

health coverage, and worker anxiety has been heightened by the shift of white-collar jobs overseas. "If you understand that employers are subject to global pressures and have to keep profits up, it may well cause employees to say, 'You know, it's not in my interest to vote in a union,'" says Charles I. Cohen, a management-side labor attorney at Morgan, Lewis & Bockius LLP.

STIFF RESISTANCE

HEIGHTENED CORPORATE POWER has checked union growth, too. Unionization elections are typically so lopsided today that most unions have all but given up on them. Most employers pull out the stops when labor organizers appear, using everything from mandatory antiunion meetings to staged videos showing alleged union thugs beating workers, backed by streams of leaflets and letters to workers' homes. While most of these tactics are legal, companies also illegally fire union supporters in 25% of all elections, according to studies of federal data by Cornell University labor researcher Kate Bronfenbrenner. That's triple the percentage of the 1960s. So companies are often able to turn employees against a union, even though a rising number of Americans have said in national polls over the past two decades that they would join one.

Most employers disagree with that assessment. They see



I'm not ready to tear down the institution in order to remake it."

—MORTON BAHR, PRESIDENT, COMMUNICATIONS WORKERS OF AMERICA

even harder. At the SEIU's 2000 convention, he persuaded delegates to set a specific recruitment spending target for all locals: 20% of their budgets, totaling \$80 million. And he got them to come up with \$50 million more for an organizing fund.

Meanwhile, Stern funneled half of the international union's \$100 million annual spending into membership growth. Overall, the SEIU and its locals devote some \$180 million a year to expansion, says SEIU Executive Vice-President Tom Woodruff.

Labor's Free Fall

Labor's share of the workforce continues to slide...

Union members as a share of the U.S. workforce

1973	24%
1983	20%
1993	16%
2003	13%

Data: Barry T. Hirsch and David A. Macpherson

...and labor leaders have failed to aggressively recruit new members.

Union representation elections

1970	7,773
1980	7,296
1990	3,623
2003	2,516

Data: National Labor Relations Board

Although millions of Americans want to join a union...

Share of 84 million nonunion workers* who say they would vote for a union at their company

1984	30%
1993	39%
2003	47%

*Private-sector nonsupervisory workforce
Data: Peter C. Hart Associates

...they often are intimidated by illegal firings of union supporters...

Share of representation elections in which a union supporter is illegally fired

1964-69	8%
1980-84	20%
1998-99	25%

Data: Robert J. LaLonde and Bernard D. Meltzer
Kate Bronfenbrenner, Cornell University

...and other union-resistance tactics.

% of employers that used union-avoidance tactics in representation elections in 1998-99

TACTIC	% OF EMPLOYERS
Hold mandatory antiunion meetings for employees	92%
Have supervisors meet individually with employees to disparage the union	78%
Hire antiunion management consultants	75%
Distribute antiunion leaflets to employees	70%
Mail antiunion letters to employees' homes	70%
Show antiunion videos to employees	55%

Data: Peter C. Hart Associates

That's nearly twice the AFL-CIO's entire annual budget.

It has worked—which is one reason even labor leaders Stern rubs the wrong way still pay him heed. While most unions are shedding members, the SEIU will hit 1.8 million by the end of the year, with only about 100,000 of the growth coming from mergers with smaller unions, says Woodruff. No other union comes close to matching such a record. Stern also has succeeded with low-skilled minorities and immigrants in high-growth occupations such as janitors and hospital aides. Their unionization is a sharp departure from the white males who historically comprised the rank and file of industrial unions.

A CLEAN SWEEP

MUCH OF STERN'S VISION for labor is honed from his own experience battling employers. Consider the case of janitors. The union long had strongholds in major cities such as New York where its 50,000 office-building janitors earn up to \$18.57 an hour, plus benefits. But across the Hudson River in New Jersey some 10,000 nonunion janitors make little more than the \$5.15 an-hour minimum wage—even though they're the same largely immigrant workers cleaning similar offices.

Four years ago, as part of a nationwide janitors' campaign, the SEIU set out to sign up the New Jersey workers. The union only had about 1,000 janitors in the Newark area and had done little to keep pace as corporate flight from Manhattan led to a boom of new offices in northern New Jersey. Stern knew he couldn't run a typical recruitment drive, one janitorial contracting company at a time: In this fragmented industry, any that agreed to higher pay would be quickly undercut by nonunion rivals.

So SEIU tackled whole markets at once. In 11 New Jersey counties, it told contractors that they wouldn't have to lift pay until the SEIU got 55% of those in their area to go along. The union then mounted strikes and rallies by would-be members and took other actions to try to force contractors to go along.

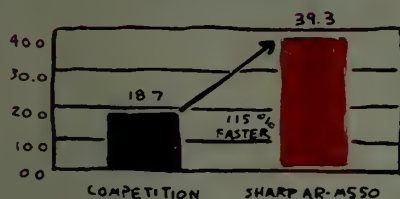
The first 55% trigger point was reached in 2001, and the union contracts took effect. By the end of this year, the SEIU will represent about 70% of northern New Jersey janitors, whose pay now ranges up to \$11.75 an hour, plus benefits. While that's still far short of the Manhattan wage, the SEIU is realistic enough to know that lower-priced New Jersey can't support the same pay. Nonetheless, unionization "has been beneficial to the industry because we're not undercutting each other, turnover is down, and workers are more dedicated and loyal," says Mark Blackburn, marketing vice-president at CSI International Inc., a privately held custodial-services company based in Red Bank, N.J., that employs 2,000 janitors in a dozen states and is the SEIU's largest New Jersey contractor.

The janitor campaign is helping low-wage immigrants reach the mainstream. Rita Cortes, who came to the U.S. from Honduras 17 years ago, had been cleaning New Jersey offices for the minimum wage since 1988. When the SEIU contract kicked in three years ago, she jumped immediately from \$5.15 an hour to \$8, plus some benefits. Today, Cortes, 54, earns \$9.75 as a nighttime office cleaner in Secaucus and will go to \$10.75 in

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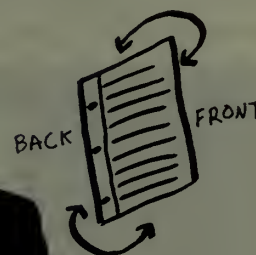
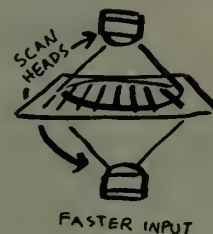
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The problem is that unions have lost their relevance to the American workplace.”

—ANDREW KRAMER, A LABOR LAW PARTNER AT JONES DAY

October. “Now my husband and I can eat better, and I get three weeks’ vacation a year, which I never had before,” says Cortes.

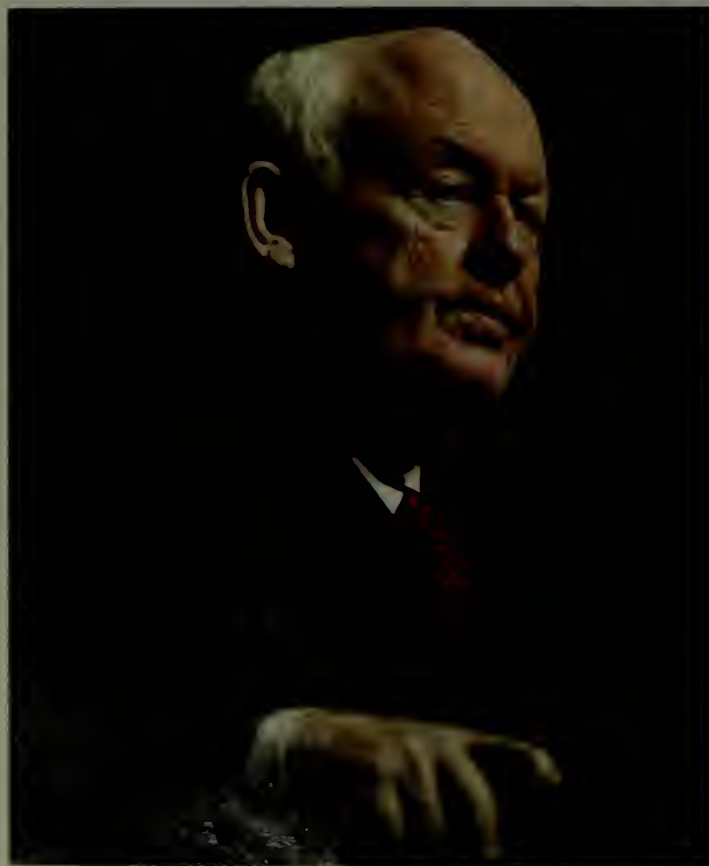
To Stern and his NUP colleagues, the lesson is elementary: Unions can’t lift workers into the middle class unless they control a significant chunk of the labor market, either geographically or by industry. Hence their focus on membership density. It’s not enough, they say, to simply increase their absolute numbers. Unions must think strategically, targeting whole areas and industries and coordinating their efforts against market forces that drive companies to undercut each other.

Few labor leaders disagree in principle, but only a handful have taken any such action. Many bristle at the notion that the

and his NUP colleagues argue, unions must gain scale, too. Today the smallest two-thirds of the AFL-CIO’s 60 unions average less than 60,000 members apiece—not nearly enough to wield market clout in most cases. Conversely, when SEIU merged the New Jersey janitors’ local into the larger, richer New York union, it could suddenly afford to commit 50 organizers and \$1 million a year to recruitment.

That local also illustrates the way many union recruitment successes occur nowadays. Rather than use a formal unionization election supervised by the federal government, the SEIU got a majority of each building’s workers to sign union authorization cards—a process known as card check. The goal is to circumvent management’s power to influence an election.

A growing number of unions—including the Communications Workers of America (CWA), the United Auto Workers, and to some degree the SEIU—have turned to card checks in recent years. There’s no official count, but unions enlist about 150,000 to 200,000 new members a year through card checks today, versus just 70,000 through federal elections, according to the AFL-CIO. This is why the federation has launched a major drive for federal legislation requiring employers to recognize unions through card checks. (Currently employers can do so if they wish but don’t have to.)



AFL-CIO would force them to recruit in specific industries, as Stern and the others are suggesting. But last year, in a white paper called *United We Win*, Stern laid out labor’s uncoordinated and overlapping structure and showed how multiple unions represent workers in the same industry. He found that there are 8 unions with a significant presence in nondurable goods such as clothing, 9 in heavy manufacturing such as autos, 13 representing government workers, and 15 each in construction and transportation. If Stern had his way, there would be one or two giant unions in each industry sector.

Clearly, in an economy dominated by corporate giants, Stern

JOHN SWEENEY

The AFL-CIO head has failed to halt labor’s steady decline in nine years at the helm

LEADERSHIP STYLE

THE IRONY OF STERN’S frontal attack on the AFL-CIO is that Sweeney has been hitting many of the same notes ever since he took over. He came to office after frustrated labor leaders gave up on predecessor Lane Kirkland, whom they thought was moving too slowly against labor’s long decline. Sweeney won a hotly contested election against Kirkland’s No. 2, Thomas Donahue, and swept to power insisting that unions devote at least 30% of their resources to new-member recruitment.

Despite their clash, Stern and Sweeney differ more in leadership style than in substance. Sweeney is an unruffled, soft-spoken man given to consensus rather than rhetoric. But his low-key cajoling has done nothing to stem labor’s membership slide, which has plunged by two percentage points under his tenure—the same rate of decline that occurred under Kirkland.

Stern, by contrast, has an intense, driven personality that propelled him into leadership roles at an early age. The son of middle-class parents in suburban West Orange, N.J., he got a Ivy League education at the University of Pennsylvania, where he gravitated toward the student movement. He joined the SEIU at 21 as a state social worker and soon became head of the local. By 29, he had vaulted onto the international union’s Executive Board, the youngest person to have made it there.

His zeal for left-leaning social causes dovetailed with the traditions of the SEIU. As a young SEIU official in the early 1980s, Stern joined other activists in the union to force through controversial resolutions opposing U.S. military intervention in Latin America. More recently he threw his union’s weight behind Howard Dean’s Presidential campaign, switching to the

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COVER STORY

more mainstream Kerry only after Dean flamed out. He also has cultivated close relations with a wide range of social leaders. (His wife, Jane Perkins, from whom he is getting a divorce, headed the environmental network Friends of the Earth in the 1990s.)

Throughout, Stern honed his organizing skills and strategic thinking. In 1995 he directed Sweeney's effort to win the AFL-CIO presidency (thus clearing the way for his own succession). The team he put together to corral votes that year outmaneuvered the more staid Donahue forces, coordinating its efforts with bright yellow T-shirts sporting the Sweeney slogan and using radio headphones that let Stern's crew keep in constant contact as they counted noses on the convention floor.

Still, it will take a masterful hand to sell his message to the AFL-CIO's 54-member Executive Council. Already, Stern's outspokenness has riled a number of union presidents who perceive him as self-serving. Critics argue—with some validity—that much of his recruitment success has come among easy-to-organize public-sector workers in home health aid and child care—not among the tough-as-nails private-sector employers that unions must prevail against to grow again. Twice in recent months at federation meetings, labor leaders such as International Association of Machinists President R. Thomas Buffenbarger blasted Stern for his attacks on the AFL-CIO.

BAD BLOOD

IN RESPONSE, STERN AGREED not to speak out again until after the November Presidential elections. Although he discussed his ideas freely with *BusinessWeek* earlier this year, Stern refused even to be photographed for this article, apparently worried that a story focused on him would further inflame colleagues.

But the bad blood lingers. Buffenbarger says he's so ticked off at Stern's high-handedness that he may quit the AFL-CIO himself. Edward J. McElroy, the new head of the American Federation of Teachers, says he will listen but remains highly skeptical.

Meanwhile, Sweeney is maneuvering for a counterattack. He told an August AFL-CIO powwow that he would set up a process



ANDY STERN

His union will spend \$65 million toward getting John Kerry elected

to discuss the NUP's ideas come November. Sweeney also will put forth his own platform, insiders say, incorporating many of those ideas. (Sweeney declined comment.) "There's going to be a showdown on all this next summer," predicts Joseph T. Hansen, president of the 1.4 million-member food-workers union, who says he is sympathetic to Stern's goals but has some reservations.

There's also the question of succession. When NUP emerged last year, Sweeney quickly announced he would run again, surprising many who had expected him to retire. Even some backers aren't sure he really will stand again, although insiders and AFL-CIO public affairs chief Denise Mitchell insist that he will.

Sweeney's retirement would open the door for 55-year-old AFL-CIO Secretary-Treasurer Richard L. Trumka, a fiery former mineworkers union president who has been underutilized by Sweeney's team but retains strong support among industrial unions. One possible compromise: a unity ticket with Wilhelm and Trumka, who have been friends for years.

The tangled politics in this close-knit group—Stern's wife has worked recently as a top Sweeney aide on environmental issues—makes any leadership battle unpredictable. CWA President Morton Bahr, an elder statesman of the federation, opposed Sweeney in 1995, figuring a power struggle was bad for labor, even though he agreed with Sweeney's goals. He feels the same today and says he stands behind the incumbent but agrees that NUP raises urgent questions. "I'll listen to what they propose, but I'm not ready to tear down the institution in order to remake it," he says.

If Stern and his NUP pals can't persuade enough union leaders that labor's near-extinction requires drastic action, the labor resort may be to form a new labor movement à la John L. Lewis. Right now, the threat is mostly a way to provoke a sense of crisis. And so far it seems to be working: America's unions are poised for an internal debate more wide-ranging than any they have had in decades. Although it's still early, one possible outcome is a more militant, pumped-up labor movement. If that happens, employers could feel renewed pressure to share with workers more of the gains from the economy's healthy productivity growth. Either way, the U.S. labor movement is in for some turbulent times. ■

BIO

Andy Stern

BORN 1950, West Orange, N.J.

EDUCATION B.A. in education and urban planning, University of Pennsylvania.

CAREER A left-wing student activist, he took a job at 21 as a social worker in New Jersey and promptly joined the SEIU, which represents many health-care workers, janitors, and other low-wage workers.

SEIU At 29, he became his union's youngest-ever Executive Board member. At 45, he became its youngest-ever president.

FAMILY Married fellow Pennsylvania SEIU activist Jane Perkins, president of Friends of the Earth in the 1990s; they are now divorcing. They have one teenage son and lost a daughter following surgery in 2002.

BusinessWeek online For interviews with leading labor leaders, go to www.businessweek.com/magazine/extra.htm.

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COMMENTARY

BY MARA DER HOVANESIAN

Put the Big Board On the Big Board

Why the nation's largest stock exchange should go public

LAST AUGUST, Thomas S. Caldwell paid \$2 million for a seat on the New York Stock Exchange. Two weeks later, then-chairman Richard A. Grasso resigned. Ever since, the seat has lost almost half its value as the exchange's market share and profits have come under pressure. No matter. On Aug. 27, Caldwell bought another seat—for \$1.15 million, the cheapest in six

years. Caldwell, an investment manager who rents seats to specialists who buy and sell stocks on the trading floor, thinks it was a bargain. How so? Sooner or later, he says, the Big Board will have to sell shares in an initial public offering and he'll make a killing.

It's an idea whose time has come. Caldwell and other NYSE seat holders want to transform the not-for-profit, member-owned exchange into a publicly traded corporation. By swapping seats for shares, they say they can capitalize on the Exchange's growth as it finally moves toward full automation—and cash out a lot more easily when times are tough. Like Caldwell, many seat holders laud NYSE Chairman John S. Reed for establishing new governance rules, restructuring the board, and paving the way for more electronic trading. But they fear the exchange's woes will persist unless ownership is expanded far beyond the current 1,336 seat holders and the "inordinate influence" of one group—the specialists, whose jobs are threatened by modernization—is removed. "Anything other than going public won't work," says Caldwell. "That is the only way we can compete on a world scale."

Going public would force the NYSE to cut costs and improve efficiency, tackle rival exchanges head-on by matching their technology, and, above all, focus on profits. It would also generate currency to acquire stakes in other exchanges worldwide to funnel trades and listings to the Big Board. And the NYSE would find it easier to raise capital for developing cutting-edge electronic trading platforms. The more the NYSE trades electronically, the more it can squeeze out costs, reduce prices, increase its trading volumes, and, ultimately, generate more revenues and profits.

The dwindling price of seats has sparked a dissident movement among owners, mostly retired Wall Streeters who rely on rent from seats for income. Some 250 members of the Association of New York Stock Exchange Equity Members are campaigning for an IPO. "In Grasso's time, they were still making lots of money," says Benn Steil, a senior fellow at the Council on Foreign Relations and an expert in financial-markets regulation. "Now they want to capitalize on their seats before there's no value left in them. Going public is the best possible exit strategy." The group's leader, retired floor broker William J. Higgins

of Pine Beach, N.J., notes that stock and commodity exchanges all over the country are publicly traded. "We're the last holdout," he says.

Historically, the main opponents of the Big Board IPO have been the specialists and independent floor brokers who operate the centuries-old open outcry system. When Grasso floated the IPO idea in the late 1990s, the specialists shot it down.

Now they're ready to deal. Plagued by downbeat trading volumes and fleet-footed electronic rivals, the collective profits of the NYSE's seven specialist firms plummeted 84%, to just \$15 million, in the first half of this year. The largest, LaBranche Co., which is publicly traded, reported second-quarter operating earnings of 2¢ a share, a third of what analysts forecast. Colin Clark, a Merrill Lynch & Co. analyst, is advising clients to sell the stock. Explains Venky Panchapagesan, assistant professor at the Olin School of Business:

THE CASE FOR AN NYSE IPO

Proponents say a listing would allow the exchange to:

- Build a broader ownership base beyond its current 1,366 members
- Create a for-profit business that would force management to focus on boosting revenue, improving efficiency, and heading off competitors
- Raise funds to acquire stakes in other exchanges, improve its technology, and develop new electronic-trading platforms
- Give seat owners a liquid, dividend-paying asset against which they could borrow

Data: Caldwell Asset Management Business Week



A DEAL?
volume
ing.
ers may
an IPO

VALUING THE NYSE

If the New York Stock Exchange goes public, it could be worth:

Between
\$900 million
at 18 times 2003 earnings
of \$50 million (based on
typical price-earnings
ratios for exchangers)

and
\$2.9 billion
at three times its book
value of \$950 million

Data: Jefferies & Co.,
Bloomberg Financial Markets

Washington University in St. Louis. "More investors are deciding they don't want intermediaries; they want to trade with each other electronically."

A Question of Timing

AN IPO WOULDN'T SPELL the end of the specialists. "The specialist role must remain," says Caldwell, "as it makes sense to provide liquidity and an orderly market for the NYSE's customers, [but] they have to make a business case, which I think they can." Specialists may even benefit as electronic trading frees them for more hands-on trading of thinly traded stocks, says Merrill's Clark. And the Securities & Exchange Commission is forcing the issue anyway by proposing to modernize the national market system unless the NYSE acts. Says Seth Merrin, president of the Internet-based trading platform, Liquidnet Inc.: "The exchange would be asking [the specialists to give up some] business, and the only way you can hope to do that is by giving them a piece of the action."

None of this ferment has escaped the NYSE board or John A. Thain, the former Goldman Sachs Group Inc. president who took over as chief executive in January. In June, the board appointed William R. Power, a 30-year veteran of commodity trading who helped the Chicago Mercantile Exchange go public in 2002, to advise it about a Big Board IPO. For now, Thain is concentrating on his August proposal to the SEC to move NYSE trading to a hybrid model that would accommodate both open outcry and

**Owners
want an exit
strategy as
the value of
an exchange
seat plunges**

electronic markets. Still, Thain has said ownership is next on his agenda. Although he said at an Aug. 2 press conference that he doesn't have "a particular view as to what the correct ownership structure is," an eventual IPO is a strong option. Thain hopes to have a business plan in place within 6 to 12 months—as a potential launch pad for going public. "Thain was instrumental in taking Goldman public," says 30-year NYSE member James Rutledge. "He has the background."

To get the best price in a public offering, the Big Board needs to beef up its earnings—a modest \$50 million last year on \$1 billion of revenues. Other listed exchanges are typically valued at around 18 times their recent earnings. By that measure, the NYSE would be worth just \$900 million. "Now is not the time" to go public, says Charlotte A. Chamberlain, an analyst with Jefferies & Co. "Earnings is what matters; the NYSE's net worth is a lot higher than that." In fact, by another measure—three times book value—the Big Board would be worth about \$2.9 billion. Caldwell, the seat buyer, figures that the exchange should be valued at about \$13 billion by calculating that it's worth at least 10 times the Toronto Stock Exchange. Adds Higgins, the dissident leader: "Google has a market cap of \$7 billion. Would you rather own Google or the NYSE?"

Toronto and other exchanges have fared well by going public. ArcaEx, which acquired the equity trading business of San Francisco's Pacific Exchange last year, trades at \$15 a share, up 30% since its IPO on Aug. 12. Toronto's 133 seats sold for about \$137,000 apiece, valuing the exchange at less than \$5 million before its November, 2002, offering, according to Washington University's Panchapagesan. Today, the exchange is worth \$1.6 billion. And the Chicago Merc's current market cap is about \$4.5 billion some 20 months after going public. If action like that comes to the NYSE some day, Caldwell won't regret having another seat at the table. ■

Nothing Like A Little Exposure

Now that funds must reveal their proxy votes, they're challenging CEOs and boards

IT'S A SAFE BET THAT QUITE A FEW portfolio managers at Fidelity Investments, American Funds, T. Rowe Price Group, and Putnam Investments won't be getting seasonal greeting cards from Michael D. Eisner this December. Key mutual funds at all four groups withheld votes for the Walt Disney Co. chief executive's reelection to Disney's board at the company's Mar. 3 annual meeting, contributing to an unprecedented 45% no-confidence tally. Subsequently, he lost the chairman's slot, though he remains CEO.

Which funds put the screws to Eisner—and which did not, including Vanguard Group funds—is one of the juicier tidbits resulting from a new Securities & Exchange Commission rule. By Aug. 31, each fund had to disclose the proxy votes it cast at companies in its portfolio in the year ended June 30. Sifting through the deluge of 3,396 filings—some fund by fund, others for an entire fund family—for a detailed assessment will take time. But a preliminary review suggests that the new rules are starting to have a subtle but sig-



nificant impact on corporate governance.

Although many funds sided with management on most matters, they often challenged companies on such hot-button issues as antitakeover defenses, lavish severance deals for CEOs, and accounting for employee stock options. Score one for the SEC. The agency instituted the rule because it worried that funds had become rubber stamps for management or didn't bother to vote at all. With billions of dollars of business from managing 401(k) plans and pensions for companies at stake, many fund groups were loath to offend CEOs who hired them for such work by voting against them or their proposals.

Knowledge that investors and the media are closely watching how they vote seems to have stiffened the spines of many fund man-

agers, say shareholder advocates. At four other companies besides Disney, votes withheld from directors exceeded 30%. At Federated Department Stores Inc., the count topped 50%. Three Allianz Group funds—CCM Capital Appreciation Fund, NACM Growth Fund, and NACM Value Fund—were among those voting no at Federated. Putnam funds voted all their shares in credit-card company MBNA Corp. against management's slate of directors.

GOOD-GOVERNANCE GAINS

WHILE DIRECTOR votes stole the headlines, the intensified war by institutional investors on poison-pill takeover defenses went almost unnoticed. Institutions deplore them because a company that can't be taken over is worth less than one that can. This year, proposals to eliminate staggered elections for directors, which effectively stop acquirers from gaining control of boards, garnered an average 71% of votes cast, up from 63% in 2003, according to Washington-based governance research firm Investor Responsibility Research Center.

Funds' antipathy to staggered terms and poison pills prompted more companies to make concessions to avoid high votes on investor proposals against them. This year, 34 companies with staggered boards offered their own proposals for annual elections of directors, while 40 put their poison pills back in the bottle. "We're seeing an increased level of responsiveness" from companies to concerns about antitakeover measures, says Glenn Booraem, a principal in charge of proxy voting at Vanguard. That, in turn, may have spurred the resurgence in mergers and acquisition this year, says Burton G. Rothberg, assistant accountancy professor at Baruch College's Zicklin School of Business.

Discerning all the patterns in fund voting won't be easy, in part because there isn't a common disclosure format. While some fund complexes, such as the Vanguard Group, set voting policies for all their funds, others, including T. Rowe Price, give individual portfolio managers leeway to vote as they see fit.

Mutual funds weren't, by any means, hotbeds of investor activism. Virtually all rejected social and political initiatives. But the exercise in disclosure, together with new stock exchange listing standards and other SEC rules, appears to be nudging funds and companies toward better governance. Shareholders can only hope that they'll keep the pressure on. ■

—By Amy Borrus in Washington, with Lauren Young in New York

Proxy Power

Mutual funds must now disclose how they vote on corporate proxies. Preliminary tallies of this year's votes suggest that:

MANY funds challenged companies on high-profile initiatives by withholding votes, as they did with Walt Disney CEO and then-Chairman Michael Eisner

SOME companies trimmed execs' golden parachutes before proxies were mailed to avoid negative votes

MANY companies dismantled their poison-pill defenses, helping to spark a merger boomlet

Data: BusinessWeek



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A Tax Paradise Right Here at Home

Hundreds of companies are setting up captive insurance units in receptive states

THINK ALL U.S. COMPANIES looking for tax havens are sending skilled jobs offshore as fast as they can? Try again. More and more are skipping the Bermudas and Cayman

Islands of the world. Instead, they're finding a tax paradise onshore when they set up in-house units to self-insure their risks. For years, Vermont was virtually the only U.S. destination for such captive insurers, but now South Carolina, Hawaii, and even the District of Columbia are entering the domestic sweepstakes.

Traditional insurance havens are rapidly losing ground. Last year, Vermont added 64 captives—20 more than longtime leader Bermuda, according to London-based Risk & Insurance Research Group. The Green Mountain State had 507 at the end of 2003, including units set up by Boston Scientific Corp. and Continental Airlines. D.C. had just five captives two years ago but added 14 last year, the same as the British Virgin Islands. Overall, seven U.S. states added a total of 175 captives last year, while the top offshore locales snagged just 109.

South Carolina is typical of the trend. After its lawmakers capped taxes on premiums paid to insurance companies, the state began aggressively marketing Charleston as a cheaper alternative to offshore havens. In Bermuda, for instance, a housing allowance for an executive can cost up to \$20,000 a month. After less than four years, the picturesque port city now has roughly 85 insurers and has applications from 25 more—turning it into the 12th-largest captive insurance domicile in the world almost overnight.

Other forces are also erasing the benefits of going offshore. Consultants and tax

attorneys say the cut in federal taxes on capital gains, coupled with U.S. demands that offshore havens share the tax records of U.S. companies domiciled there, has leveled the playing field. "Up until the '90s you could do things offshore and no one would ever know about it," says



Keeping Captive Insurers in America

Several states are making it attractive for insurers owned by companies to set up in the U.S. instead of in exotic tax havens

LOCATION	NUMBER OF CAPTIVES 2003	PERCENT CHANGE FROM 2002
Vermont	507	14%
Hawaii	122	21
South Carolina	67	123
District of Columbia	19	280
Bermuda	907	5
Cayman Islands	644	7
British Virgin Islands	296	5

Data: Risk & Insurance Research Group

Michael Mead, president of the Chicago insurance consultancy M.R. Mead & Co. "Now, the [Internal Revenue Service] knows where every penny you have is."

INTO THE POOL

COSTS WERE A BIG ISSUE for the Washington Contract Loggers Assn. last year after it decided to offer group liability coverage to its 1,000 member companies. It found they could save 10% to 40% if they pooled their risks and self-insured. The Olympia (Wash.) group also decided that setting up a captive in Washington, D.C. was cheaper than doing so in Bermuda. "And since you hear about everybody flying the coop to go offshore, we thought it was important to stay here," says Jerry Chertude, who manages the group's insurance program.

The eventual payoff for a state can be big. Vermont began recruiting captives in the 1980s and they now generate \$1 billion in annual economic activity. "We're equal to the lottery now" in terms of economic impact, declares Leonard D. Crouse, director of Vermont's captive-insurance division.

Some states insist—shades of the age-old complaints about Bermuda and the Caymans—that companies are unfairly sheltering profits onshore by placing far more reserves with their insurance units than necessary. In the Democratic primaries, Senator John F. Kerry charged that former Vermont Governor Howard Dean had created "a snowy Bermuda in the fields of Vermont."

Some states are taking their grudges to court. Since 2000, Illinois has sued Waste Management Inc. and Exxon Mobil Corp., saying they used Vermont captives to underpay Illinois state taxes. Waste Management and Exxon deny the charges, and the suits are pending. The criticisms are "sour grapes," says Ernest N. Csiszar, South Carolina insurance director until last month, adding that companies "are not allowed to reserve for more than the risk warrants."

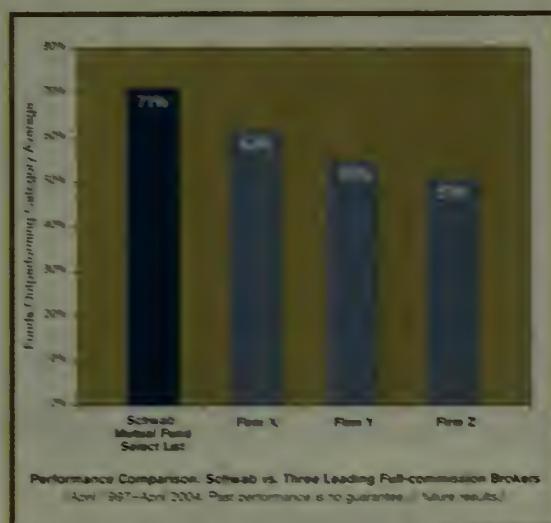
For its part, Bermuda questions whether states rushing to become insurance havens have the knowhow to avoid defaults or other blowups that could leave the insured holding the bag. Susan V. Attride-Stirling, assistant marketing director for the Bermuda Monetary Authority, posits that "some of the states are setting up regulations that are more accepting than perhaps we would be." Vermont and South Carolina say that's not the case. For now, the insurance business is no longer a captive of the Caribbean.

—By Dean Foust in Atlanta

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NEW SCENARIO
Gates is betting
video will give
Microsoft an edge

Microsoft, The Entertainer?

Gates & Co. take aim at Apple's iPod—but their first attempts could fall short

SINCE THE DAWN OF THE PC era, you would be hard pressed to find much that Apple Computer Inc. CEO Steven P. Jobs and Microsoft Corp. Chairman William H. Gates III agreed on. Now that Apple has reinvented itself as the king of the digital music world, Microsoft is trying to wrestle that mantle away with a new breed of iPod rivals, including ones that play color video as well as music. It's one more instance of clashing world views. "We don't think people have a burning desire to watch

video on tiny little screens," Jobs said earlier this year. But Gates points to the growing phenomenon of kids watching videos during long car trips as proof that there is a market for small screens. "I guess Steve's kids just listen to Bach and Mozart," Gates quips. "But mine, they want to watch *Finding Nemo*. I don't know who made that, but it's a really neat movie." Of course, Gates knows: It was Jobs's own Pixar Animation Studios.

When the boss gets sardonic, you can tell Microsoft is getting serious about a market. On Sept. 2, the company is launching its most comprehensive foray

yet into the digital media world. Portable video players, which run on Microsoft software and are made by Samsung Group and others, are just a piece of the tech giant's plan to steal Apple's rock 'n' roll mojo. Microsoft also is opening the doors to an online music store that includes a handful of popular artists that Apple's iTunes site doesn't have, such as Radiohead. More important, the company is rolling out an update of its Windows Media Player audio and video software that's designed to make it just as easy to purchase and manage music with Microsoft-powered gear as it is with Apple's iPod and iTunes combo. "There's nothing that the iPod does that I say: 'Oh, wow, I don't think we can do that,'" Gates says.

The digital media push is aimed at helping Microsoft recapture a measure of its youth. The company has been wrestling with questions about maturity as its growth slows. Analysts expect that as the digital media market grows over the next few years it could contribute \$400 million to Microsoft's revenues. While that's a fraction of its \$36.8 billion annual take, the company is hoping



over time to generate far more meaningful revenue for its MSN unit by jump-starting the sale of low-cost digital goodies.

SHOWTIME The Samsung portable media player stores video and music

Once music shoppers give MSN credit card numbers to buy songs, Gates believes they'll be more willing to buy other products Microsoft is developing, from text-messaging services to digital characters that can be used as personalized icons for instant messaging. "There's a lot that has to be done to make it really comfortable and easy to spend small amounts of money online," Gates says. "Music is definitely one of the applications that's going to bootstrap that kind of consumer

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The new technologies are also key to Microsoft's march into the living room. If consumers get used to Windows Media Player and the portable video and audio players, they're more likely to use the company's technology as they shuttle digital content around their homes. Wide customer acceptance may help Microsoft persuade record labels and movie studios to wrap their music and video in its software. The idea is that the cycle could feed on itself, making Microsoft's media technology as ubiquitous as its Windows monopoly. “You don't have anybody investing more in bringing these consumer scenarios together,” says Gates.

Yet for all the effort, Microsoft isn't going to displace Apple anytime soon. The stylish, simple elegance of Apple's iPod, together with its pioneering iTunes download service, has come to define digital music. It has sold nearly 4 million iPods and more than 100 million

songs, and its momentum shows no signs of abating. By comparison, Microsoft hasn't shown the flair that's necessary in digital entertainment. It's relying on partners to gin up iPod killers, and to date, they haven't come close to Apple's allure. And even as Microsoft's partners are improving their designs, so is Apple, making its lead that much more difficult to overcome. “The iPod has transcended being a consumer device and become a cultural icon,” says Jupiter Research analyst Michael Gartenberg.

With the iPod so strong in the digital music biz, Microsoft thinks that video-on-the-go may be its best chance to pull ahead long term. There, it sees a market that looks an awful lot like the digital music business did just five years ago. Back then, about 13% of Web-connected U.S. homes had music files on their PCs, according to Jupiter. That's roughly the same percentage as those who have digital video files today, according to tech research firm the NPD Group Inc. Now, 63% of Web-connected U.S. homes have music stored on their PCs. Microsoft's devices, which record video as well as songs, can untether

prerecorded TV shows and movies so people can watch them wherever they want. The first devices, by Samsung, Creative Technology, and iRiver, will store 20 gigabytes of digital content—about 80 hours of video or 5,000 songs. “Video is definitely the gee-whiz factor here,” says Lisa O'Malley, a senior brand manager at Creative Technology Ltd.

The gadgets, though, aren't likely to kick-start a video revolution anytime soon. Their biggest drawback is simply that they're inconvenient. Users can copy video only from a PC, not directly from a television or DVD player. IDC analyst Roger Kay estimates that fewer than 1% of the world's computers have the TV tuner cards that are required to copy TV programming. Those can be bought for \$70, but even then the only way to watch the latest episode of, say, *The Daily Show with Jon Stewart* on a Portable Media Cen-

ter is to connect a cable jack to a PC, copy the show onto a computer, and then download it to the portable device. Although there are no restrictions on copying television shows now, broadcasters could impose them in the future. To avoid all the bother, customers will need to pay companies that have partnered with Microsoft to provide content directly from the Net. That presents another problem: Microsoft has lined up only two video content providers so far, Major League Baseball and CinemaNow Inc. MLB.com and the movie site have less than 2 million monthly customers combined.

HEFTY AND PRICEY

COPYING HASSLES ASIDE, the products are hefty and pricey, at \$500 each. Adding video capabilities adds bulk and reduces battery life to at most seven hours while watching videos, vs. as many as 20 hours for music-only devices. Design is a big deal because, as Apple has proved, cool devices are the key to winning the digital media battle. Consumers pick a device first. Everything else is secondary. All of which likely will relegate the first generation of devices, about the size of a paperback book, to niche status. Especially since there already are viable alternatives for watching videos on the go. “There are a lot of them out there already. They're called notebook computers,” says Mike McGuire, research director at GartnerG2.

Analysts aren't willing to write off the long-term potential for portable video gadgets. Microsoft's partners could speed up design, and Microsoft eventually will make video transfer more convenient. That could help the technology become much more popular toward the end of the

The new media players' biggest drawback? They're not easy to use

Sound and Fury: Microsoft's Digital Media Strategy

On Sept. 2, Microsoft is unveiling an offensive to strengthen its position in the digital media market. But the push likely won't match Apple's runaway success anytime soon.

VIDEO TO GO Samsung, Creative Technology, and iRiver are launching Portable Media Centers. These \$500 handheld devices, about the size of a paperback book, can play TV shows, movies, and music. They may catch on eventually. But the first versions are bulky and expensive and can copy programs only from PCs, not from TVs.

COMPETING MUSIC STORE Microsoft is introducing its online music store on its MSN portal. While the service will eventually offer as many songs as Apple and let users quickly buy songs as they hear them on Web radiocasts, it doesn't differ much from other music retailers. Apple's pioneering iTunes is building on its momentum and expanding overseas.

REVVED-UP MEDIA SOFTWARE Microsoft is bringing out an updated version of its Windows Media Player software that plays digital video and music. The approach is clever. The updated software makes it a snap to buy or rent digital music and movies and download them to a new breed of mobile devices.

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decade, analysts say. "This is the first shot across the bow," says Jupiter's Gartenberg. "When it comes to Microsoft, the first shot is never the most important."

Microsoft's work in digital music holds more immediate promise. The new Windows Media software has mimicked iTunes, letting users buy in one click songs from MSN Music and a handful of other music retailers and have the tunes automatically added to music libraries. But unlike iTunes, MSN Music has agreed to carry music from artists who only want to sell entire albums online, instead of individual songs. That's a small number of artists, including Radiohead and the Dave Matthews Band, and may not prove to be much competitive advantage. Fans of the groups who prefer the iPod can always go to a retail store to buy their music. Still, Microsoft plans to add innovations over time, including letting users hover their cursors over names in their MSN Messenger buddy list to see what songs their friends are listening to.

VANISHING MUSIC

ANOTHER BIG innovation is a feature that for the first time lets people who use music subscription services transfer their rented tunes to portable devices. That means customers of Napster Inc., for example, will be able to add as many songs from the service's one-million-song library as they can fit on their portable players. The technical breakthrough, to reassure the record labels, is that songs disappear from devices when the customer's subscription expires.

Still, the record labels are extracting a price for the newfound freedom. They want more money to let consumers put subscription songs on a portable device—they believe, rightly or not, that customers who subscribe will spend less money buying music. Napster Chairman and CEO Chris Gorog says the company will hike the monthly subscription fee from \$10 to at least \$15 for the portable service. That's likely to limit the market, since \$180 a year is a hefty tab for music that will vanish once the subscription lapses.

Gates has grand plans for how Microsoft can change the world of digital media. "Media today is so far short of what it can be," he says. But he'll have to do more work to get the company's strategy in tune with its ambition. ■

—By Jay Greene in Redmond, Wash.,
with Peter Burrows and Cliff Edwards
in San Mateo, Calif.

BusinessWeek online For an interview with Microsoft Chairman Bill Gates, go to www.businessweek.com/magazine/extra.htm

MOVIES

Gates Tries for A Hollywood Ending

It looked like a boffo debut for William H. Gates III and his attempt to go Hollywood. Two years ago, flanked onstage by Oscar-winning *Titanic* director James Cameron and rapper LL Cool J, the Microsoft chairman unveiled his company's latest version of its audio and video software. But Microsoft Corp.'s upbeat show hit a dark second act. Holding court later in a suite at the Four Seasons Hotel, Gates delivered what one Hollywood mogul called "a second-grade tutorial" on the economics of selling movies online. It was "a little uppity," says the mogul, "even for the richest man on the planet."

Someone must have sent in a script doctor. Since the debacle, Microsoft has phased out the geeks in favor of Hollywood

InterTrust Technologies Corp., a copy-protection technology maker that's partly owned by Sony Corp.

The new approach is helping Microsoft make headway. It won nonexclusive software licensing deals with Time Warner and Walt Disney Co. Time Warner is considering making its content available to PCs and portable devices that use Microsoft's Media Center software. Disney is looking at using Microsoft's software to deliver movies and TV shows over the Net. Microsoft has also won approval to include its encoding software in the next-generation HD DVDs, including the new Blu-ray format backed by Sony.

Still, the studios remain wary of Microsoft, given its bruising monopolistic practices of the past. Hollywood execs, originally concerned that they would have to pay for every movie or show digitized using Microsoft's software, were relieved at the company's willingness to provide it for free under a 10-year agreement. But the historical distrust lingers. "Sounds great, but studios are waiting for what happens in the 11th year, when Microsoft says it has Windows 15 and it's gonna cost you a bundle," says Richard Doherty, research director at the Envisioneering Group, a consultancy that has advised studios in the past. At the same time, these strategies have raised the hackles of competitors. In December, rival RealNetworks Inc. filed suit, charging Microsoft's practice of giving away software to content providers was part of a pattern of anticompetitive behavior.

Hollywood is being careful to avoid becoming dependent on Microsoft. The five studios that own the MovieLink movie download service use software from both Microsoft and RealNetworks. And despite its recent deal with Microsoft, Disney shows no inclination to drop the copy-protection technology that it licenses from Switzerland's NagraVision to protect movies on Disney's MovieBeam video-on-demand service for TVs.

Tinseltown execs may still love a tale of redemption. But it may take more than a new script for Microsoft to remake itself from villain to hero. ■

—By Ronald Grover in Los Angeles



MOVIE DREAMS Will Tinseltown use Microsoft video software?

insiders, such as former Warner Bros. Inc. DVD chief Warren Lieberfarb. In July, Microsoft hired Blair Westlake, former chairman of Universal Television & Networks Group, to run a newly created unit to lobby Hollywood. Their goal? Persuade the studios to wrap their movies in Microsoft's software, which the company is offering for free. That way, Microsoft can turn around and sell the software that plays these digital versions of movies to computer makers, consumer-electronics companies, and online video services.

Microsoft is smoothing over its legal disputes as well. During the past year, the company settled lawsuits with Time Warner Inc.'s Netscape unit and tiny

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COMMENTARY

BY DAVID WELCH

Detroit is Over a (\$50) Barrel

The Big Three aren't ready to compete with foreign rivals on fuel economy

OIL PRICES HAVE FLIRTED with a record \$50 a barrel in recent weeks, and gas still hovers around \$2 a gallon across much of the U.S. But in Detroit, it feels like business as usual. In late August, General Motors Corp. Chairman and CEO G. Richard Wagoner Jr. was on Woodward Avenue in Royal Oak, Mich., watching a parade of vintage Mustangs, GTOs, and other muscle cars—symbols of a day when companies didn't even bother telling you what kind of mileage their cars got. And to drive home the point that Motown still has gasoline running through its veins, Wagoner brought with him about a dozen copies of a new 390-horsepower version of the Chevrolet SSR sport pickup. When asked if pricey oil was hurting sales of GM's gas-guzzling trucks and sport-utility vehicles, Wagoner was dismissive: "We haven't seen it having an effect so far."

That sound you hear out of Detroit these days is a lot of whistling past the graveyard. For the past decade—the auto industry's fat years, when average annual sales of 17 million cars and trucks generated big returns—the U.S. Big Three invest-

ed much of their profits in horsepower. The resulting muscle-bound trucks and bulky SUVs proved wildly popular, and probably saved Motown's hide. In the meantime, though, the Japanese and Europeans—whose home markets have long had more expensive fuel—were investing in a host of fuel-efficient technologies. So while Wagoner is showing off a new SSR, Toyota Motor Corp. is boosting production capacity of its 50-mile-per-gallon Prius by 50% and plans the launch of another gas-electric hybrid, the Lexus RX 400h luxury SUV, this fall. Ford Motor Co. will soon launch the first American hybrid, a nearly 40-mpg version of its Escape SUV. But Honda Motor Co. is about to sell its third hybrid, an Accord, promising at least 240 horsepower and fuel economy that tops 30 mpg. The Europeans, meanwhile, are pushing clean diesel engines, which get at least 30% better fuel economy. And all foreign auto makers have a jump on selling "crossover" sport-utes, which are built using the understructure of a car, thus offering buyers the cavernous confines of a big SUV but with a smoother ride and better fuel economy.

For now, as gas prices ease off a bit with the end of the summer travel season, Detroit feels like it has a reprieve. But in an age of terrorism, that could change overnight. And if oil suddenly spikes upward, Detroit's fuel-efficiency gap could be reminiscent of the '70s, when young buyers flocked to smaller Toyotas and Hondas, and Detroit was left flat-footed. U.S. carmakers say that won't happen again, that they are already ramping up production of smaller SUVs, launching

Japan is miles ahead in crossover SUVs and hybrids



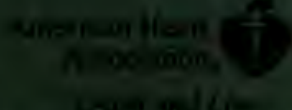
GULP If gas prices take another leap upward, Detroit could see its market share slide



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The Corporation Strategies

more hybrids, and charging engineers with finding ways to wring more efficiency out of today's gasoline engines. But little of that is ready for prime time—in fact, most of the new technology won't be evident for a couple of years.

Even at today's gas prices, customers are starting to vote with their feet against big SUVs. Detroit execs argue that SUV and truck sales are still strong, even for monsters like the 15-mpg Chevrolet Tahoe and Ford Expedition. Indeed, sales of truck-based SUVs—which account for most of Detroit's automotive profits—are up 1.3% so far this year. But look closer: Nearly 50% of consumers who are trading in a traditional truck-based SUV buy something else, says Art Spinella, president of CNW Marketing Research Inc. in Bandon, Ore. Buyers are leaving to make a fashion statement as much as to save gas. But in any case, the vehicles they're choosing—smaller SUVs and luxury cars—are more likely to be foreign-made.

Indeed, sales of less-efficient truck-based SUVs are only still rising because auto makers are laying out as much as \$6,000 in rebates. That's richer than the deals being offered on any other type of vehicle. Margins, as a result, are suffering for all the U.S. carmakers. Says Detroit-area Chevy dealer Gordon Stewart: "They're overcoming the fuel-cost increase with incentives that you can't believe."

EATING JAPAN'S DUST

For now, many American consumers still crave the SUV's enormous interior cabins and commanding ride height. But if fuel prices become an issue, those comforts could quickly be-



Easing Up on the Gas

There are a number of ways to make cars more fuel efficient, but Detroit trails in most of them.

CROSSOVER SUVs Sport-utility vehicles built on a car platform have the passenger space of larger, truck-like SUVs, but their lighter frames and more aerodynamic designs make them more efficient. Motown has only 39% of the crossover market, vs. 60% of all vehicles.

HYBRIDS Using an electric motor to assist the gasoline engine boosts fuel economy by as much as 40%. Toyota and Honda are on their second and third generations of hybrids, like the Prius (above). Only Ford has one close to market among U.S. companies; GM's are three years away.

VARIABLE VALVE TIMING Fuel intake is electronically controlled to optimize efficiency, boosting economy by 5%. Honda and Toyota use it widely, but the Big Three each have just a few models using the technology.

Almost half of those who sell their big SUV opt for a smaller vehicle

come an expensive—and nonessential—luxury. CNW Marketing surveyed consumers earlier this year and the results showed that some consumers will look for more efficient vehicles when gas prices hit \$2.25. But they will have a bigger change of heart if prices hit levels of \$2.50 or higher and remain there for three to six months. Then, Spinella says, the shift into hybrids and smaller vehicles would accelerate.

Car-like SUVs such as the Honda Pilot already are an attractive alternative. The Pilot gets 19 mpg, a 19% improvement over the truck-based, 16-mpg Explorer. Both seat seven. The Japanese jumped out to an early lead in crossovers partly out of necessity—Toyota and Honda didn't have big truck frames with which to enter the booming SUV business. But the products were so successful they quickly changed the market. Today crossovers account for 1.7 million sales per year, triple the number sold back in 2000. The Big Three have just 39% of the crossover market in the U.S., compared with their 60% stake of the overall vehicle market. The domestic share is growing, thanks to successes like Ford's Escape, a small crossover that sells almost 170,000 a year. GM has a few, but its bigger push into crossovers won't come until 2007.

The hybrid race is even more lopsided. Detroit waited while Honda and Toyota blazed a trail, adding a small electric motor to boost power and in some instances to take over for the gas engine. Now Toyota and Honda have been selling hybrid-electric cars for seven years, working out the kinks and priming consumers to think of it as trustworthy technology. It will be three years before GM offers a hybrid system on its new full-size SUVs. That will be more robust than the 10% mileage boost that commercial-fleet buyers now get with a "mild" hybrid version of the Chevrolet Silverado truck. GM execs argued that they could make a bigger impact on fuel consumption and tailpipe emissions by adding hybrid systems to their big SUVs than the other guys were through hybrid small cars. But with the shift that's under way, by the time the hybrid trucks arrive Detroit could be defending a smaller market.

To be sure, no one knows how big a market hybrids will become. The technology adds \$2,000 to \$5,000 to the cost of building each vehicle, some of which gets passed on to the customer. But as gasoline stays close to \$2 a gallon, hybrids can only get more attention. Dealers already have waiting lists for the Prius.

If prices shoot back up again, the domestic manufacturers have a few levers they could pull relatively quickly. They could sell more trucks with V-6 engines instead of gas-gulping V-8s. GM is working on a conventional gasoline engine that can improve fuel economy by up to 20% using, among several technologies, an engine that shuts down some cylinders to save fuel when the vehicle is cruising at highway speeds. Chrysler has this in its 300 sedan and GM will offer it in its mid-size SUVs next year.

And as a last resort, auto makers could quickly recalibrate their cars to have less power. Changing the gears to reduce power to the drive axle can cut gas use by 5% to 10%. But the trade-off is a slower car. Therein lies the problem: Foreign auto makers already deliver fuel savings with fewer compromises. After years of pumping up U.S. sales with horsepower and price incentives, Detroit is scrambling to catch up in fuel-efficient technologies. For the next couple of years, U.S. car execs can only cross their fingers, watch oil markets, and hope for the best. ■

Time to Hedge on Hedge Funds?

New research shows that returns are sliding, and some don't help you diversify. **BY ANNE TERGESEN**

HEDGE FUNDS ARE HOT. Since 1999, their assets under management have nearly quadrupled, to about \$800 billion, as investors have flocked to them in search of superior returns and a refuge from the stock market's gyrations. But evidence is growing that these private pools of capital—known for using sophisticated strategies off-limits to many mutual funds—aren't performing as well as they did in the past. Worse, some types of hedge funds aren't delivering much of the diversification that reduces portfolio risk—one of the big advantages of these pricey investments. Hedge-fund flaws have become more apparent recently, under the microscope of newly developed evaluation techniques. Indeed, although hedge funds are often measured against the returns of the Standard & Poor's 500-stock index or U.S. Treasury bonds, researchers are devising new ways to size up the track record of this relatively young asset class—which behaves differently

CRAIG FRAZIER

How They Stack Up

Hedge funds still deliver more return, on average, for each unit of risk taken than other asset classes





from stocks, bonds, and other investments. Using new yardsticks, the investing prowess of hedge-fund managers appears less impressive than previously thought. "People seem to believe the story that with hedge funds, the returns are all attributable to someone's skill," says Laurence Siegel, director of investment policy research at the Ford Foundation. "But we can separate the manager's contribution from the part due to market exposure, and the manager's added value is often smaller than what hedge funds would like you to believe."

At first glance, hedge-fund returns look pretty good. Since 1990 hedge funds have earned an average of 11.9% a year, according to Citigroup, which recently published a study on performance. Over the same time, the S&P 500 and the average stock mutual fund have risen 10.5% and 9.2%, respectively. Moreover, when you look at the risk-adjusted returns that many hedge-fund investors care about, hedge funds come out ahead of stocks and bonds. But on a risk-adjusted basis, hedge-fund performance has declined in recent years—and it isn't expected to rebound anytime soon. Although there's only a short history of data from which to draw conclusions, "the managers are performing less well than they have historically," says Neil Brown, managing director at Citigroup Alternative Investments.

One explanation for the falloff is a decline in trading opportunities. With both stock market volatility and interest rates at low levels, managers have fewer arbitrage plays to exploit, says Charles Gradante, managing principal at Hennessey Group, a New York adviser to hedge fund investors. This common hedge-fund strategy involves betting on price discrepancies between investments. Furthermore, with the explosive growth in hedge funds—the estimated 7,000 today is double 1999's number—more managers are chasing fewer profitable potential trades. Because of the lower returns projected for the stock market, Citigroup forecasts that the average annual return to hedge funds will decline to 10.1% for the foreseeable future.

BETTER HANDLE

THAT'S NO SMALL matter to investors, who pay dearly to invest in these private funds, which are generally open to those with net worths of \$1 million or more. A hedge-fund investor can expect to fork

Declining Performance

The degree to which hedge funds have outperformed their benchmarks has declined in 11 of the following 12 categories.

CATEGORY	OUTPERFORMANCE*	
	1990-1997	1998-2003
Convertible Arbitrage	2.29%	6.1%
Distressed Securities	7.8	3.3
Event Driven	7.6	3.3
Equity Hedge	8.2	3.6
Equity Market Neutral	2.3	-2.0
Equity Non-Hedge	7.5	2.3
Fixed Income Arbitrage	8.5	1.9
Merger Arbitrage	5.9	3.2
Macro	7.4	3.5
Relative Value Arbitrage	7.9	3.9
Short Selling	6.8	4.1
Statistical Arbitrage	2.0	-1.4

*Numbers are calculated on an average, annual basis. The outperformance is in comparison to benchmarks for each hedge fund category.

Data: Citigroup

over 1% to 2% of the account balance every year to cover management fees. That's not too different from the average mutual fund, which charges about 1.5% a year. But hedge funds typically pocket about 20% of any profits they generate, while regular fund investors keep all the gains after expenses.

Thanks to new methods of evaluating hedge funds, investors can also get a better handle on how much diversification they're likely to get. In the case of some types of hedge funds—Citigroup tracks 12 styles—the answer is not much. For example, you can replicate 93% of the movement in returns of "equity non-hedge" funds—so named because they aren't fully protected, or hedged, against stock market declines. How? You can buy exchange-traded funds (ETFs) and other securities that track indexes, including the Russell 3000 and the MSCI Emerging Markets. Because the hedge funds move with these and other indexes, they offer little diversification to investors whose portfolios are already exposed to investments in the areas the indexes cover.

Other hedge funds that may offer little diversification, given their exposure to such common assets as value and small-cap stocks, include "short-selling" funds that bet against stocks and the "equity hedge" funds that balance exposure to

CLASS	RETURN PER UNIT OF RISK*	
	1990-2003	FUTURE PROJECTION
Hedge funds	1.30	0.65
Bonds	0.87	0.14
U.S. stocks	0.40	0.27

*Measured by the Sharpe Ratio, which gives the excess return to the amount of risk taken

Data: Citigroup

stocks with short positions, according to Citigroup (table, page 105). In contrast, the research indicates that arbitrage funds specializing in both mergers and fixed income largely march to their own beat and so can add diversification.

The new research also answers a key question: What portion of hedge-fund returns is attributable to the widely trumpeted skills of managers, vs. the fortunes of the markets? The good news: On the whole, managers make a difference. The bad: Their skills don't seem as sharp as they were. In recent years, of the 12 styles Citigroup tracks, 11 experienced declining "alpha"—investment-speak for the return that can't be explained by the market's movements and is assumed to be the result of the manager's hand (table, page 105).

To figure out whether managers are earning their keep, Citigroup researchers examined 12 indexes published by Hedge

Fund Research, each covering a different style within the hedge-fund universe. After adjusting the past results—for instance, by adding back the failed funds deleted from these indexes—the researchers used statistical methods to estimate what portion of the past returns are attributable to traditional markets, such as commodities, stocks, currencies, and bonds. The rest—the unexplained portion of the returns—is the manager's contribution.

The analysis gauges whether a manager delivers more than investors can get with a basket of index funds. "In some cases, you're paying high hedge-fund fees even though markets drive a significant portion of a manager's returns,"

The good news: On the whole, managers do make a difference

says Ryan Meredith, quantitative analyst at Citigroup Asset Management and the Citigroup study's lead author. Fund categories that delivered lower "alpha" from 1998 to 2004 are "equity market neutral" and "statistical arbitrage," each of which attempts to minimize market exposure, in part by balancing long and short positions.

Still, despite the recent performance trends, hedge funds on average continue to deliver better risk-adjusted returns than many other asset classes. So if you can afford them, by all means, shop around. But make sure to pick funds with skilled managers that add diversification to your portfolio. Otherwise, you may get very little for those hefty charges. ■

Stocks

The Web 20: Bruised But Still Strong

Some Net players remain resilient despite the recent drubbing. **BY TIM MULLANEY**



SINCE 2002, OUR *BUSINESS-Week* Web 20—a selection of established and profitable Internet companies designed to show how ordinary investors can play Net stocks without undue risk—has performed superbly. The model portfolio rolled up a 71% gain in its first year and followed with a 24% rise in the six months ended in March. Then came the second-quarter earnings season, and half of our picks got whacked. Since Mar. 1, we're down 6%. Ouch.

We're chastened, but still believers. Forrester Research recently raised its

forecast of U.S. e-commerce growth, saying last year's \$114 billion market will double by 2007. Jupiter Research says U.S. Web ad sales will jump from \$6.6 billion in 2003 to \$13.8 billion in 2007. As tough as July's selloff was, our Web 20 is still performing as well as the market. Its recent loss basically matched the 4.8% dip in the Standard & Poor's 500-stock index, and clobbered NASDAQ's 10.7% drop. (You can follow the month-to-month fortunes of the Web 20—formerly called the BW Real World Internet Index—by going to www.business-week.com/web20.)

To maintain a high level of performance,

twice a year we review the list of stocks, scratching disappointing (or acquired) players and adding up-and-comers.

This time, we've axed the University of Phoenix Online, which was acquired by majority owner Apollo Group Aug. 27, along with online ad-services company DoubleClick, Web-conferencing software leader WebEx Communications, e-tailer 1-800-Flowers, Internet service provider United Online, and Digital Insight, which makes software for online banking sites.

With all the controversy over Google's valuation in its August IPO, we paused to

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Stocks

consider whether to include the search-engine giant on our list. Even at recent stock prices of around \$102 a share, we think it's a good long-term bet. Google trades at 31 times its 2005 earnings, after factoring out noncash charges for stock options. Skeptics argue that Google needs to be cheaper than elite Web players Yahoo! and eBay. It is: Its 2005 price-earnings ratio is about half of Yahoo's and 40% lower than eBay's. Standard & Poor's analyst Scott Kessler figures Google cash flow can grow nearly 80% a year through 2009. That may be high, but it leaves wiggle room.

Type the word *diamonds* into the Google box and the first name that pops up (under sponsored links) is another of our Web 20 additions, e-tailer Blue Nile. The Seattle-based online jeweler peddles diamond rings for up to 35% less than brick-and-mortar jewelry chains and needs only a small warehouse to sell as much bling-bling as 116 stores. Operating margins are nearly twice the jewelry-industry average, at about 9% versus 5%, and management focuses on profits, not growth at all costs. "It's how we survived," CEO Mark Vadon says.

Analysts expect Blue Nile's profits to grow 33% next year. The stock, first offered to the public in May, is pricey at 50 times 2004 estimated earnings, but Forrester says the U.S. online jewelry and luxury-goods market will nearly double, to \$5.3 billion, by 2007. That gives Blue Nile, with \$129 million in 2003 sales, room to grow.

Flowers is a more established e-tailing category than jewelry, thanks in large part to 1-800-Flowers. Still, we're removing it from our list in favor of an emerging competitor, Provide Commerce, which runs Proflowers.com. These two might look like Frick and Frack, but they're not. 1-800 sells mostly through local stores that handle delivery. Provide deals with growers who ship directly to customers overnight. Analysts say Provide will earn \$10 million

in the June, 2005 fiscal year, up from around \$8.5 million in 2004.

WHOSE RESURGENCE?

RECENTLY, OUTSOURCING tech work to India has surpassed even e-tailing in generating buzz. Few Indian outsourcing companies have better prospects than Bangalore-based Infosys Technologies. Earnings are expected to grow 28% a year for five years, enough to justify its p-e of 35. We like the 2.5% dividend, too.

We added Double-Click last March to

bet on the resurgence of the U.S. online-ad market, but it posted a weak second quarter, cut second-half earnings projections, and saw its stock fall 50%. A better choice: aQuantive, a Seattle agency with lines of business DoubleClick lacks. "We're probably more of a proxy for online advertising," than DoubleClick is, says aQuantive CEO Brian McAndrews. AQuantive's Razorfish unit is a leader in writing and producing online ads.

It has also moved faster toward business models that let it charge premium rates when ad lead directly to a sale. Analysts say aQuantive earnings will be up 26% next year, to \$20 million after rising 41% this year.

Finally, we are betting on e-finance by restoring IndyMac Bancorp, an original Web 20 member we dropped last summer. The Pasadena (Calif.) mortgage bank has won kudos for a Web-linked broker network that has made it

highly efficient. We thought the waning refinancing boom would kill profits. Instead they're expected to rise 24%, to \$212 million. With interest rates rising more slowly than expected, analysts think earnings will grow 19% next year. Plus, it pays a 3.8% dividend.

At an average of 36 times 2004 earnings, the Web 20 stocks are more than twice as expensive as the S&P 500. Still Net-industry earnings should grow four times faster than S&P profits next year. In that light, they don't look so pricey. ■

The BW Web 20

STOCK*/SYMBOL	PRICE**
Amazon.com AMZN	\$38.31
Ameritrade AMTD	11.68
aQuantive AQNT	8.65
Blue Nile NILE	26.18
Checkfree CKFR	27.11
Ctrip.com CTRP	30.08
Digital River DRIV	24.61
eBay EBAY	85.51
E*Trade Financial ET	11.83
Google GOOG	102.01
IAC/InterActiveCorp IACI	23.18
IndyMac Bancorp NDE	34.06
Infosys Technologies INFY	50.62
Netflix NFLX	14.45
Priceline PCLN	20.88
Provide Commerce PRVD	18.41
Sina SINA	21.20
Symantec SYMC	47.53
WebSense WBSN	38.51
Yahoo YHOO	28.46

*New members are listed in red. **Aug. 30
Data: Bloomberg Financial Markets

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Bikes On Steroids

The new breed of cruisers is bigger, badder, and a tad pricier. **BY ROB DOYLE**

THAT OBJECT IN YOUR MIRROR may be larger than it appears, especially if it's one of these so-called mega cruisers. They're long, low, and wide—and cost more than a small car. These motorcycles measure about eight feet from nose to tail, yet you sit just over two feet off the road. Such behemoths tip the scales at roughly 800 pounds. That's not much when you're rolling along, but it's a lot when you're pushing it over that half-inch lip into your garage.

Cruisers make up more than half of all on-road motorcycle sales, and the new breed of big ones is an attempt by makers to better distinguish their brands from Harley-Davidson and its signature Fat Boy, which has long ruled this class. They've got huge, high-tech engines—some of them come in at two liters or more—and plenty of low-end torque for fast getaways from a standing stop. They're the biggest bikes ever mass produced, SUVs for the motorcycle set.



KAWASAKI VULCAN 2000

\$14,499

⚡ Head-on, the distinctive polished-chrome headlight assembly of the 2004 Kawasaki Vulcan 2000 echoes that of a streamlined locomotive. The bike pulls like one, too. The massive 2,053 cc fuel-injected V-twin engine generates nearly 120 foot-pounds of torque, which makes for fast starts. The engine is built to look and stay cool, with both high-tech liquid cooling on the top and high-style cooling fins on the cylinders below. The bike with the biggest V-twin engine on the market, the Vulcan makes the Harley Fat Boy look as if it's on a low-carb diet.

HONDA RUNE

\$24,449

✂ The 2004 Honda Valkyrie Rune is an exercise in extravagance. Honda designers had free rein: They borrowed the 6-cylinder, 1,832 cc engine from Honda's flagship Gold Wing touring bike and modified it for more power. Components for the rear suspension came from the company's racing bikes. Everything is fitted to a diamond-shaped aluminum frame. The result is a bike that looks like nothing less than a one-off, custom cruiser that will have people asking for the name of your builder.



TRIUMPH ROCKET III

\$15,990

⚡ The largest production bike ever made, the British-built 2004 Triumph Rocket III looks like a '60s hot rod, with flashy exhaust pipes cascading from its fuel-injected, 2,294 cc power plant. The resemblance doesn't stop there: The in-line engine's three pistons are as big as those in a Dodge Viper roadster. They easily produce a massive 147 ft.-lb. of torque, the exhilarating power you feel during acceleration, and transfer it to the road through a prodigious nine-inch-wide rear tire.

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Vehicle shown with available equipment. ¹Toyota Vehicle Stability Control (VSC) is an electronic system designed to help the driver maintain vehicle control under adverse conditions. It is not a substitute for safe driving practices. Factors including speed, road conditions and driver steering input can all affect whether VSC will be effective in preventing a loss of control. Please see your Owner's Manual for further details. ©2004 Toyota Motor Sales, U.S.A., Inc.



Must-Have Toys For HDTV Buffs

Receivers with built-in DVRs make recording programs a cinch. **BY LARRY ARMSTRONG**

THESE ARE TOYS FOR rich folk: \$1,000 digital video recorders that can handle high-definition TV signals. They work like the DVRs designed for standard television broadcasts made by the likes of TiVo and ReplayTV, letting you pause live TV programs, get instant replays, or record and store shows so you can watch them later. They're the must-have missing piece of the system for home-theater buffs—the easy way to record programs broadcast in HD.

For the past couple of months, I've been comparing two high-definition, satellite-TV receivers with built-in DVRs: DirecTV's HR10-250 and DISH Network's DVR-921. They're the most powerful DVRs on the market, letting you record two different HD programs at the same time you're watching a third, previously recorded one. (Some cable-TV companies are beginning to offer HD DVR set-top boxes, but they can record only one show at a time.)

"TRICK PLAY" FEATURES

TO USE THEM, you'll need a satellite dish and an HD-capable TV set. Both DISH and DirecTV offer a half-dozen or so HD channels for about \$10 a month, plus HD versions of premium channels Showtime and HBO. Both have channels for special



SURFING? DISH Network's program grid is user-friendly

local stations, you'll also need an off-air antenna, the old-fashioned "rabbit ears" or rooftop type. Both boxes will seamlessly integrate the local TV and satellite TV listings into the same on-screen program guide.

The two high-definition DVRs offer the usual "trick play" features, such as skipping back 10 seconds for a second look, pausing a show to answer the phone, or fast-forwarding through commercials. But that's where the similarities end. If you're a channel-surfer who watches TV in real time—as the shows are aired—but you want to record an occasional series or movie, the DISH DVR-921 is for you. If most of what you watch are shows and movies you've already recorded, your

events, such as the Olympics, that are broadcast in HD. If you want to get HD signals from your

SMART SEARCHER DirecTV's DVR will locate programs for you

best bet is the DirecTV DVR, which uses technology licensed from TiVo.

That's because the

strengths and weaknesses of each machine skew it toward one type of TV viewer or the other. For example, channel-surfers will find the 921's program-listing grid easier to navigate, with buttons on the remote to skip ahead in 24-hour chunks. The DirecTV program grid moves only in 30 minute increments and, even then, is slow enough to be almost unusable.

On the other hand, if you subscribe to the TiVo paradigm of watching mostly prerecorded TV, you don't really need a grid. Instead, you can rely on the DirecTV DVR's robust search features to seek out and record those programs you're interested in. You specify a title, actor, director, or key word, and the DirecTV box will continuously look for it and record it, even if it's a movie that airs a year from now. For series, it can distinguish between first-run episodes and repeats, and it can spot shows that air at

different times on different days, handy for *American Idol* fans. The DISH 921 can only record the same time slot daily or weekly, like a VCR, and it can search only eight days ahead for shows already listed in its program guide.

There are some other differences. You can pause the DISH 921 for

up to two hours and still rewind to the beginning of the show; DirecTV is limited to 30 minutes. DISH's fast-forward and rewind buttons let you race through a recorded program much faster. DISH can hold 25 hours of HD programs on its built-in hard-disk drive while DirecTV can store 30 hours (or 180 and 200 hours, respectively, of standard television).

A word about bugs. DISH was first to market last December but throttled back production because the 921 didn't live up to its promises. I experienced several instances where it forgot to record a program. That was corrected with a software upgrade it automatically installed in August. There's still no program information for local channels, although the channels are listed in the guide. DISH says the problem will be fixed in October.

Still, if you can't bear to miss an episode of your favorite show, both of these DVRs are now up to the job. ■



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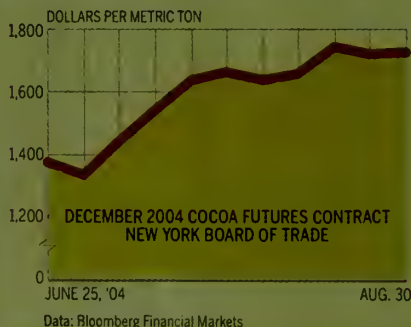
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COMMODITIES

SUMMERTIME, AND THE COCOA IS HOT

THE SUMMER HAS been sweet for cocoa traders: After a two-year downturn in prices, futures on the New York Board of Trade have spiked by more than 25% since late June, to \$1,700 per metric ton. Heavy buying by hedge-fund managers as well as too little rain in the Ivory Coast, where 40% of the world's crop is grown, are fueling the rally.

Prices are not expected to stay high for long. "The dry weather may have been overplayed," says Luis Rangel, vice-president of commodities at brokerage **Fimat USA**. That means chocoholics probably won't be paying more for their truffles and other treats next year. Or if they are, it won't be because of the cost of cocoa.



ONLINE POLL

DO YOU USUALLY book your business flights through an airline Web site, by calling the carrier, through your corporate travel desk—or in some other way? **Is price paramount in selecting a carrier, or does scheduling still count?** To answer these and other

questions, log on to BusinessWeek Online (www.businessweek.com/go/airsurvey/) and complete our airline survey. Do so, and you'll be eligible to win a two-night stay at select Starwood Hotels and Resorts. The deadline for filling out the short questionnaire is Oct. 3. Results will appear in a special business travel section in mid-October.

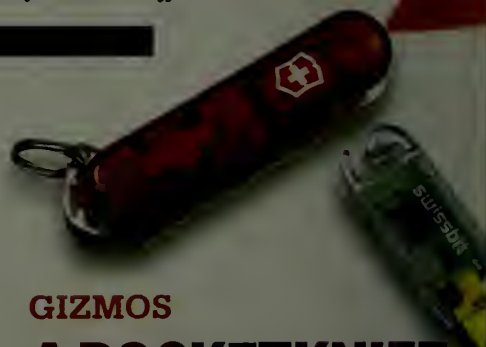


TRAVEL

Toasting the Grape

NOW YOU'VE HEARD IT through the grapevine: It's the best time of the year for a trip to Northern California wine country. With the harvest running through October and the Bay area's best weather setting in, wineries in Napa and Sonoma counties are sponsoring outdoor festivals, classes, and special tastings. Meet the winemakers. Sample the goods. Enjoy the food and music.

The festivities kick off Labor Day weekend, but plenty is happening throughout the month. In Napa, the free **Wine & Crafts Faire** on Sept. 11 features 200 arts and crafts vendors and wines from the region. Beginning on Sept. 17, **St. Supery Winery** offers a \$250 "harvest adventure" that includes breakfast, instructions on grape-picking, tours, and a Cabernet-blending seminar. Over in Sonoma on Sept. 11-12, Chaka Khan, Bobby Caldwell, and Harold Jones's Big Band will headline "Jazz on the River." Or how about this: On Sept. 18, build an outhouse racer—yes, it's what you think it is on wheels—and test your driving skills (707 887-9841). To get a complete schedule and check prices, go to winecountry.com. —Cliff Edwards



GIZMOS

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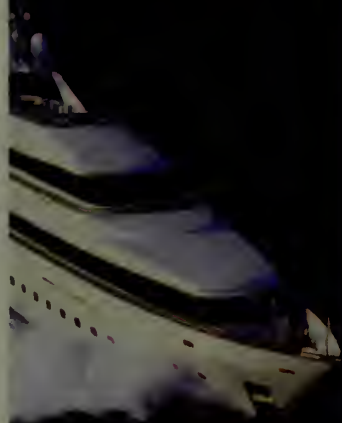
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BY ROBERT BARKER

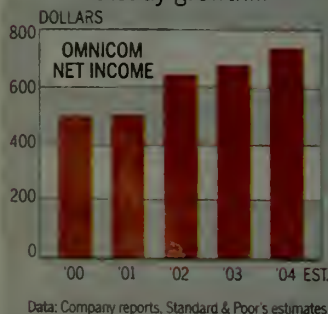
Omnicom: Investors Are Missing the Story

On both Madison Avenue and Wall Street, everybody's wondering about the possible sale of Grey Global Group, last of the big independent ad agencies. All summer its bankers have been rounding up potential bidders, such as marketing titan WPP Group, that have eyes for Grey's prized Procter & Gamble account.

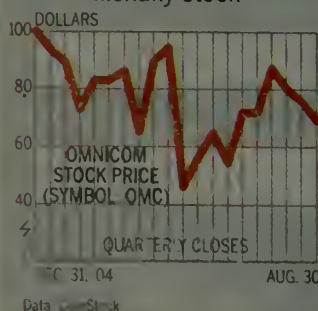
Yet despite all the interest in Grey, I'm keeping my focus on Omnicom Group. Shares of the world's largest advertising, public-relations, and marketing services company are badly lagging the broad market. Near \$70, they're off 20% this year—even though the company keeps growing nicely (chart). Company execs aren't talking. But if Omnicom, which already owns BBDO Worldwide, DDB Worldwide, and TBWA\Worldwide, were to bid for Grey, its stock might fall further—creating an even richer opportunity for investors.

OPPORTUNITY

Steady growth...



...shaky stock



To see why I think Omnicom isn't properly appreciated, it may help to recall how ad agencies have been depicted on popular television shows. On TV, such admen as Darrin Stephens (*Bewitched*) live a boom-bust life of late-night brainstormers and 4 p.m. hangovers. Sudden account wins or losses have them either breaking out the bubbly or plop-plopping Alka-Seltzer. Omnicom's results belie that image. Over the past five years, its net income rose steadily (chart). Unusual? Of 1,441 companies in Morningstar's Principia database with \$1 billion or more in sales, fewer than 9% saw a net income rise in each of those years.

The New York company stands out this way not just because of its scale (\$9.2 billion in revenue over the



past 12 months and 5,000 clients). Also helping to damp volatility are its diversity (44% of sales from ad work, the rest from PR and such specialty services as arranging promotional sports events) and its balance (55% of revenue from the U.S., 45% from abroad). Nor has it hurt that in the late-'90s boom, Omnicom kept its head when making acquisitions. Omnicom "is the only major company to escape unscathed through the dot-com bubble," notes Tim Fidler, research director at Ariel Capital Management, which owns a big Omnicom stake.

MCDONALD'S AD
Omnicom's cash flow looks tasty

SO WHAT'S WEIGHING ON THE STOCK? Worry over the strength of economic growth, certainly. But two accounting issues also may be sowing confusion. First, Omnicom voluntarily began this year to charge the cost of employee stock options against its earnings, a discipline most companies haven't adopted yet. Second, Omnicom in 2001-03 sold \$2.3 billion in convertible notes. Now a pending change in their accounting treatment will cut Omnicom's diluted earnings per share. How much is uncertain, but Omnicom estimated this year's second-quarter diluted earnings per share would have been about 7% lower.

None of this affects Omnicom's underlying strength. S&P sees net income this year growing nearly 9%, to \$734 million. In the past 12 months, Omnicom generated \$599 million in free cash flow (that is, cash from operations less spending on capital projects and acquisitions) and spent \$313 million to buy back shares. It's also paying out \$169 million at current annual rates via a 90¢-a-share dividend. Ariel, which paid an average of \$67 a share for its stake, figures Omnicom is worth perhaps \$99 a share to a private buyer. Whether Omnicom captures Grey Global or not, it's set to thrive. ■

E-mail: rb@businessweek.com

The middle can be a perfect way to balance your portfolio.

While we all strive for diversification in our portfolios, there's no exact science to ensure we achieve it. MidCap Spiders (MDY) are certainly a step in the right direction. They're exchange traded funds (ETFs) that give you the entire basket of S&P MidCap 400 stocks in one shot. Every share represents the heart of the market's middle. You can buy, sell and trade MidCap Spiders all day long just like a stock. And they have very low management fees*. Ask your advisor for details. It's a question of balance. www.MidCapSPDR.com. Ticker symbol Amex:MDY. The entire S&P MidCap 400 in every share.



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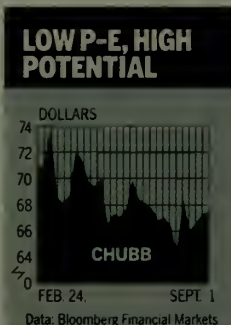


BY GENE G. MARCIAL

WITH STRONG RESERVES, CHUBB SHOULD WEATHER THE STORM
IN AN EARNINGS SLUMP, WASHINGTON MUTUAL IS WORTH A LOOK.
A CHINA PARTNERSHIP BOOSTS RAE SYSTEMS' PROSPECTS.

Chubb's Safe Harbor

THE HURRICANE SEASON is here, signaling dire prospects of big damage claims against property and casualty insurers. And with Hurricane Frances threatening Florida, insurance stocks are being battered. But to Robert Stovall, managing director at Wood Asset Management, now is the time to buy shares of Chubb (CB): It's a "top-quality major insurer that is well equipped in claim reserves and resources to weather the storm," says Stovall. The stock, down to 67.34 from 74 in March, is undervalued, he says. It was featured in this column on Jan. 16, 2003, when it was at 56. Stovall notes that Chubb is now trading at an historically low price-earnings ratio of 9.7, based on analysts' 2004 consensus estimate of \$6.96 a share, vs. 2003's \$4.46. Their 2005 forecast is \$7.62. Hurricane Charley, which hit Florida in August, cost insurers about \$7.4 billion, according to industry estimates. Of that, Chubb, which mostly insures upscale homes, estimates it probably will shoulder some \$40 million—well below analysts' forecasts. Gary Wood, CEO of Wood Asset, which owns shares, says Chubb is his top choice in the group for its growth prospects and conservative management. He expects it will raise its premiums again. Alain Karaoglan of Deutsche Bank Securities, which owns shares and did banking for Chubb, says the stock is cheap: Now trading at 1.7 times its estimated 2005 book value of \$51.23, it should jump to 85 in a year, he says.

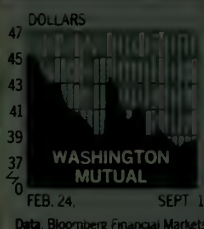


Washington Mutual: Treasure from the Deep?

WASHINGTON MUTUAL (WM), the world's largest savings bank, with assets of about \$280 billion, has become something of a pariah on the Street: Not one major analyst rates it a buy. Earnings from mortgage lending of \$489 million in the second quarter of 2003 swung to a \$63 million loss in 2004's second quarter—forcing WM to lower its earnings forecast for 2004 and ax 2,500 from its mortgage banking staff. WM invested heavily in its mortgage business by expanding its workforce and offices, assuming that the mortgage boom would continue. But the rise in interest rates cut volume and crippled earnings. Its stock fell from 45 in February to 38. Enter value players: John Maloney, president of

M&R Capital Management, which sold its WM shares a year ago at 43, is buying now. "That's value investing—buying tormented stocks that have great chances of recovering from their grief," he says. He believes WM could hit 44 in a year, when he expects its mortgage woes to be fixed. In a year, WM could be back at "a respectable earnings run rate of \$200 million in mortgages," he says. So it could earn \$3.70 a share in 2005 and \$4 in 2006, up from an estimated \$2.85 in 2004. Erik Eisenstein of Standard & Poor's, who rates WM a hold, sees its retail store banking—which will add 250 locations this year on top of the 250 opened in 2003—as a source of new earnings growth.

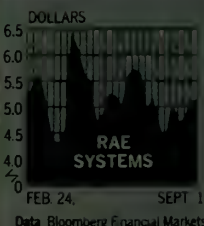
A BOON FOR VALUE PLAYERS?



Detecting the Heat In RAE Systems

DESPITE THE CONCERN over terrorism, many high-flying security-related stocks have been shot down. One small outfit that some pros say could turn out to be a long-run winner is RAE Systems (RAE), a maker of chemical and radiation detection monitors. The stock's drop from 6.50 in April to 5.12 "creates an attractive entry point," says Gary Leibowitz of Jefferies, who rates it a buy. Jefferies has done banking for RAE. RAE has partnered with China International Marine Containers, a large cargo container manufacturer, which is testing RAE's detectors in three shipping routes. The company expects they will be successful. Kevin Dede of securities firm Merriman Curhan Ford, who also rates RAE a buy, notes Homeland Security is also testing RAE's monitors to detect hazardous materials in containers. Leibowitz figures RAE will earn 6¢ a share on sales of \$44.6 million in 2004 and 10¢ on \$57 million in 2005. ■

"AN ATTRACTIVE ENTRY POINT"



BusinessWeek online Gene Marcial's Inside Wall Street is posted at businessweek.com/today.htm at 5 p.m. EST on the magazine's publication day, usually Thursdays. See Gene on Fridays at 1:20 p.m. EST on CNNfn's *The Money Gang*.

Note: Unless otherwise noted, neither the sources cited in Inside Wall Street nor their firms hold positions in the stocks under discussion. Similarly, they have no investment banking or other financial relationships with them.

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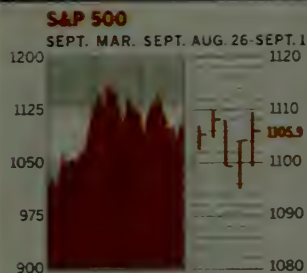
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Personal Business Figures of the Week

STOCKS



COMMENTARY

The Dow Industrials, NASDAQ, and Standard & Poor's 500 were virtually unchanged during the week ended Sept. 1 on light trading before the long Labor Day weekend. While a rise in manufacturing activity suggested good news on the economic front, a drop in oil inventories spooked the market and sent oil prices up after seven trading days of declines.

Data: Bloomberg Financial Markets, Reuters

U.S. MARKETS

	SEPT 1	WEEK	% CHANGE YEAR TO DATE	% CHANGE LAST 12 MONTHS
S&P 500	1105.9	0.1	-0.5	9.7
Dow Jones Industrials	10,168.5	-0.1	-2.7	8.0
NASDAQ Composite	1850.4	-0.6	-7.6	2.2
S&P MidCap 400	581.4	0.9	0.9	12.1
S&P SmallCap 600	279.9	0.6	3.5	15.0
DJ Wilshire 5000	10,763.6	0.3	-0.3	10.2

SECTORS

BusinessWeek 50*	635.9	0.9	2.2	10.6
BW Info Tech 100**	323.3	-0.3	-7.7	2.3
S&P/BARRA Growth	539.4	-0.1	-3.0	5.8
S&P/BARRA Value	562.5	0.3	1.9	13.7
S&P Energy	258.9	3.9	15.5	29.0
S&P Financials	385.0	-0.3	1.4	13.2
S&P REIT	127.8	1.4	10.4	21.8
S&P Transportation	201.9	0.2	0.0	12.8
S&P Utilities	126.9	1.3	7.2	19.4
GSTI Internet	137.2	-2.5	-5.2	2.3
PSE Technology	656.0	-1.0	-5.9	3.9

*Mar. 19, 1999=1000 **Feb. 7, 2000=1000

GLOBAL MARKETS

	SEPT 1	WEEK	% CHANGE YEAR TO DATE	% CHANGE LAST MONTH
S&P Euro Plus (U.S. Dollar)	1147.5	1.2	-2.7	1.1
London (FT-SE 100)	4502.0	2.0	0.6	0.6
Paris (CAC 40)	3613.2	0.5	1.6	0.6
Frankfurt (DAX)	3817.6	0.8	-3.7	6.1
Tokyo (NIKKEI 225)	11,127.4	0.0	4.2	4.4
Hong Kong (Hang Seng)	13,023.9	1.8	3.6	19.1
Toronto (S&P/TSX Composite)	8410.1	0.5	2.3	12.1
Mexico City (IPC)	10,329.8	0.9	17.4	35.1

FUNDAMENTALS

	AUG. 31	WEEK AGO	YEAR AGO
S&P 500 Dividend Yield	1.72%	1.73%	1.62%
S&P 500 P/E Ratio (Trailing 12 mos.)	19.5	19.4	28.7
S&P 500 P/E Ratio (Next 12 mos.)*	16.2	16.0	17.2
First Call Earnings Revision*	-2.66%	0.06%	0.02%

*First Call Co.

TECHNICAL INDICATORS

	AUG. 31	WEEK AGO	YEAR AGO
S&P 500 200-day average	1111.7	1110.4	Negative
Stocks above 200-day average	52.0%	50.0%	Neutral
Options: Put/call ratio	0.73	0.82	Positive
Insiders: Vickers NYSE Sell/buy ratio	3.05	2.92	Negative

BEST-PERFORMING GROUPS

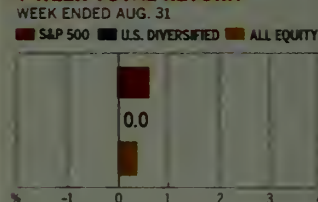
	LAST MONTH %		LAST 12 MONTH %
Photographic Products	12.5	Internet Software	73.7
Internet Retail	11.9	Steel	67.8
Gold Mining	10.7	Oil & Gas Refining	62.3
Homebuilding	9.7	Internet Retail	58.2
REITs	8.0	Homebuilding	50.3

WORST-PERFORMING GROUPS

	LAST MONTH %		LAST 12 MONTH %
Semiconductors	-11.5	Semiconductor Equip.	-25.1
Specialty Appr. Retailers	-11.2	IT Consulting	-21.1
Employment Services	-10.1	Semiconductors	-20.1
Instrumentation	-9.6	Airlines	-20.1
Advertising	-8.2	Advertising	-17.1

MUTUAL FUNDS

4-WEEK TOTAL RETURN



52-WEEK TOTAL RETURN



Data: Standard & Poor's

EQUITY FUND CATEGORIES

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		LEADERS	
Precious Metals	5.5	Latin America	30.6
Real Estate	5.4	Natural Resources	29.1
Pacific/Asia ex-Japan	4.6	Real Estate	27.6
Diversified Emerg. Mkts.	4.0	Europe	23.1
LAGGARDS		LAGGARDS	
Technology	-2.1	Technology	-8.0
Natural Resources	-1.7	Small-cap Growth	0.4
Small-cap Growth	-1.2	Mid-cap Growth	1.5
Miscellaneous	-0.6	Large-cap Growth	2.4

EQUITY FUNDS

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		LEADERS	
ProFds. Pr. Mtls. Ustr. Inv.	12.0	American Heritage	66.7
Matthews Korea	10.7	iShares MSCI Austria Idx.	62.4
iShares MSCI S. Kor. Idx.	10.3	Bruce	54.6
Fidelity Advsr. Korea A	9.5	ProFds. Wriss. Ultsr. Inv.	54.6
LAGGARDS		LAGGARDS	
GE Contra	-44.4	GE Contra	-98.9
ProFds. Smicdr. Ultsr. Inv.	-13.1	ProFds. Smicdr. Ultsr. Inv.	-38.2
Frontier Equity	-8.3	Grand Prix A	-33.1
Apex Mid Cap Growth	-8.2	Ameritor Investment	-32.4

INTEREST RATES

KEY RATES

	SEPT 1	WEEK AGO	YEAR AGO
Money Market Funds	1.02%	1.02%	1.02%
90-Day Treasury Bills	1.58	1.54	0.97
2-Year Treasury Notes	2.40	2.40	1.58
10-Year Treasury Notes	4.12	4.26	4.60
30-Year Treasury Bonds	4.93	5.08	5.25
30-Year Fixed Mortgage†	5.69	5.80	6.49

†BankQuote

BLOOMBERG MUNI YIELD EQUIVALENTS

Taxable equivalent yields on AAA-rated, tax-exempt municipal bonds, assuming a 30% federal tax rate.

	10-YR. BOND	30-YR. BOND
General Obligations	3.44	3.44
Taxable Equivalent	5.14	6.54
Insured Revenue Bonds	3.71	3.71
Taxable Equivalent	5.39	6.96

THE WEEK AHEAD

BEIGE BOOK Wednesday, Sept. 8, 2 p.m. EDT

The Federal Reserve will issue its roundup on regional economic activity ahead of its Sept. 21 monetary policy meeting. Respondents to the latest Action Economics survey say they expect the Fed to hike interest rates by another quarter percentage point, to 1.75%, at that meeting.

INSTALLMENT CREDIT

Wednesday, Sept. 8 3 p.m. EDT Consumers probably

added \$7 billion in debt in July, after taking on \$6.6 billion in June.

EXPORT-IMPORT PRICES

Thursday, Sept. 9, 8:30 a.m. EDT

Export prices most likely increased by 0.3% in August, following a 0.4% gain over July. Import prices probably climbed 1% last month, after a 0.2% rise in the prior month. The price of crude oil, which topped \$48 per barrel in August, is a big reason for the expected jump.

PRODUCER PRICE INDEX Friday, Sept. 10, 8:30 a.m. EDT

Producer prices are forecast to have risen 0.3% in August, after a 0.1% gain in July. Minus food and fuel, core prices were probably up 0.2%, after inching up by 0.1%.

INTERNATIONAL TRADE Friday, Sept. 10, 8:30 a.m. EDT

The July foreign trade deficit probably narrowed to \$52 billion. In June, the trade gap surged to a record \$55.8 billion.

The BusinessWeek production index climbed to 224.9 for the week ended Aug. 21, an increase of 13% from the previous year. Before calculation of the four-week moving average, the index moved up to 225.6.

BusinessWeek online

For the BW50, more investment data, and the components of the production index visit www.businessweek.com/magazine/extra.h

2004 FALL UNDERGRADUATE REVIEW

A GUIDE TO FEATURED DEGREE PROGRAMS



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WASHINGTON STATE UNIVERSITY

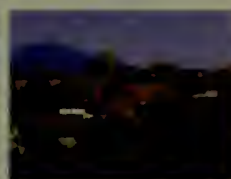
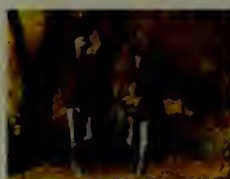
Washington State University ranks among the top 50 public research universities in the nation, providing motivated students unique collaboration with world-class faculty. WSU offers cutting-edge programs in 245 undergraduate and 70 graduate fields of study including 41 doctoral offerings, and has outstanding facilities with state-of-the-art technology.

The main campus is located in southeastern Washington, a region of extraordinary beauty with rolling hills, pristine lakes, and mountains. Students can prosper in a college-town atmosphere with a community that truly appreciates its University.

Rich discussions, leadership opportunities, internships, and study abroad challenge and reward WSU students. They benefit from an intellectually stimulating environment, interactions with diverse, high-achieving classmates, and faculty and staff dedicated to each student's personal and academic success.

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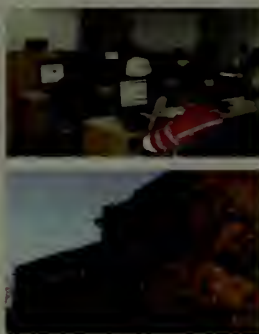
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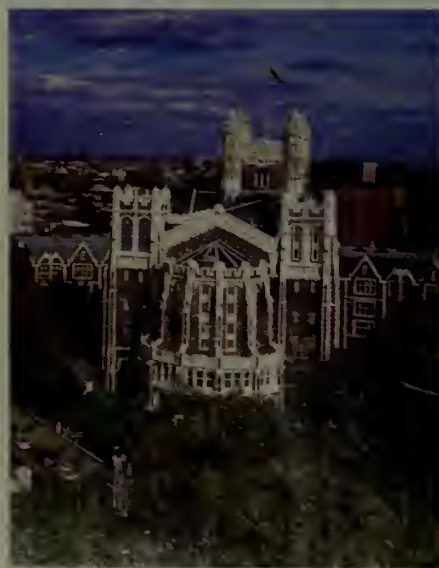
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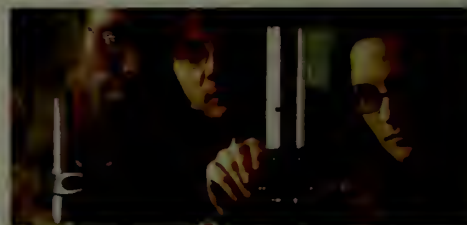
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For more than 150 years, City College has been a land-mark of diversity, opportunity and academic fire, powering alumni success stories ranging from Ira Gershwin to Jonas Salk to Colin Powell to eight Nobel Prize winners.

Today, 12,500 students pursue their dreams in engineering, architecture, education, medicine and the liberal arts and sciences on the undergraduate, masters and doctoral level on its 35-acre campus in the heart of upper Manhattan.



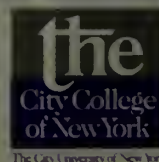
Shepard Hall anchors CCNY's landmarked campus.



Biomedical Engineering from B.S. to PhD.

One of the hottest programs at CCNY is its new Biomedical Engineering Department in the School of Engineering, an urban model and magnet for undergraduates and graduates nationwide. The faculty is widely recognized for imaginative work that integrates the worlds of cell biology, biomechanics, cell and tissue transport and biosignal processing.

City College's BME grads will apply what they learn about the physiology of the body to develop models for cell and organ function, apply medical imaging and instrumentation to study brain function and epilepsy, or create the biotechnology that's associated with drug delivery and tissue engineering.



2004 FALL UNDERGRADUATE REVIEW

A GUIDE TO FEATURED DEGREE PROGRAMS



UNIVERSITY OF SOUTHERN CALIFORNIA, MARSHALL SCHOOL OF BUSINESS Los Angeles, CA • 213.740.8885 • www.marshall.usc.edu

USC is the only top-ranked private research university in the Western United States offering an undergraduate major in business. The university's commitment to excellence in undergraduate education earned USC the *Time/Princeton Review's* "College of the Year" award in 2000. The 2001 "How To Get Into College" *Newsweek/Kaplan* guide chose USC as one of America's nine "hottest schools," and the AAC&U named USC a "Leadership Institution" in undergraduate education.

USC's Marshall School of Business is one of the few business schools that combines a diversity of students, world-class research and scholarship, and excellence in business education. Undergraduate core requirements provide students with a comprehensive intellectual foundation and Marshall students have complete access to the rich variety of courses and minors offered across USC. Located in Los Angeles, one of the world's most diverse cities and gateway to the Pacific Rim, Marshall

is dedicated to strengthening its position as a global center of business education. The university also maintains one of the largest, most supportive alumni networks in the world.



At the center of campus, Doheny Library is a masterpiece of architecture and interior design.



Business Degree Program

2004 *U.S. News & World Report* ranked Marshall's undergraduate program as #11. Students pursuing a degree in Business Administration or accounting combine in-depth knowledge of theory, real-world practical learning in business, and a solid foundation in the liberal arts and sciences. This preparation uniquely equips graduates to deal with a rapidly changing, complex world. Focusing on leadership development and the acquisition of managerial skills, Marshall emphasizes communication, analytical decision making and teamwork. Exchange programs give exposure to the multicultural nature of global business. The integration of broad-based business knowledge and an area of expertise prepares students for productive careers or for undertaking advanced professional studies.



UNIVERSITY OF
SOUTHERN CALIFORNIA

THE GEORGE WASHINGTON UNIVERSITY

GW's accredited undergraduate business programs are among the world's best, and its fields in finance, entrepreneurship, and international business are renowned. While GW's distinguished faculty engages students at the highest academic level, a GW education extends beyond the classroom. Students gain significant advantage in the job market through research with faculty, student-team projects, and experiential learning – consulting for

major corporations or small businesses; participating in study-abroad immersion programs; developing leadership skills and ethics; and networking with executives. In 2005, the school will move into a new building with wireless classrooms and a capital markets room, where students will access real-time quotes and learn portfolio management.

GW's Washington, D.C., location enables students to appreciate the relationship between business and its environment. The University's neighborhood includes headquarters and offices of corporations, nonprofits, and governmental organizations. In addition to hosting speakers from Washington institutions like the Federal Reserve, Nasdaq, and World Bank, GW provides entrée to internship opportunities through which professional careers are initiated prior to graduation.

Washington, DC • 202.994.7536 • business.gwu.edu/bw



Business Degree Program

GW's Bachelor of Business Administration (BBA), a top 50 program, focuses on general management. Students can select a field in business economics and public policy; finance; human resources management; information systems; international business; marketing; or sport, event and hospitality management. The Bachelor of Accountancy (BAccy) is highly structured and prepares students for accounting careers or graduate study. Students have several five-year undergraduate/masters program options. The First Year Development Program offers an immediate introduction to current business topics and appreciation of business' role in the community, while co-curricular programs strengthen leadership and teamwork skills.



THE GEORGE
WASHINGTON
UNIVERSITY
WASHINGTON DC

2004 FALL UNDERGRADUATE REVIEW

A GUIDE TO FEATURED DEGREE PROGRAMS

COLORADO TECHNICAL UNIVERSITY

Colorado Technical University offers a variety of associate's, bachelor's, master's and doctorate programs that are designed to provide students with a traditional education as well as experience using modern, industry-current equipment.

At CTU, programs are designed around you and your busy schedule. With innovative and flexible classes, you can complete your



The natural beauty of the Rocky Mountains is yet another reason why students choose CTU

undergraduate degree in as little as 18 to 36 months.

CTU strives to create the most positive academic experience. The professors at CTU have more than impressive academic credentials — they also have extensive experience as career professionals. With modern facilities and current computer and industry applications, you can learn and apply the most recent industry trends.

Small classes and labs allow for greater one-on-one interaction. As a student, you can become part of a comfortable, friendly community and learning environment. Financial Aid is available for those who qualify.

Admission Advisors are available to talk to at all Colorado locations: Colorado Springs: 719.598.0200 and North & South Denver: 303.694.6600.

Colorado Springs, CO • 719.598.0200 • www.coloradotech.edu



Featured Degree Programs

Colorado Technical University is a progressive place to learn in a positive and challenging environment. Your traditional education is enhanced with hands-on training on industry-current equipment for a complete learning experience.

Get the training that can help you "soar to success" with one of these undergraduate degrees from Colorado Technical University: Bachelor's or Associate's in: Accounting, Business Administration (with your choice of concentration in Human Resource Management, Logistics/Supply Chain Management, Management, Marketing and Sales Management), Computer Engineering, Computer Science, Computer Systems Support, Criminal Justice, e-Business, Electrical Engineering, Electronics Technology, General Studies, Health Care Information Technology, Information Technology, Information System Management, Network Systems Security, Project Management, and Visual Communications.



INDIANA UNIVERSITY

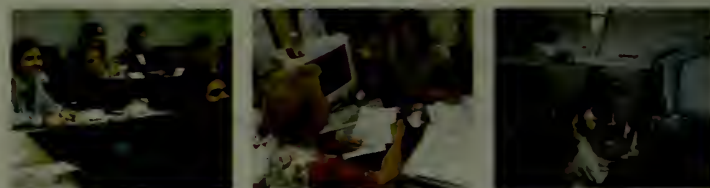
Indiana University (IU) Bloomington provides a rich tradition and excellent academic opportunities including extensive study-abroad programs. Established in 1820, IU Bloomington is recognized worldwide for its top-ranked programs



in business, informatics, music, arts and sciences, public and environmental affairs, education, and journalism. In fact, undergraduate students can choose among some 130 majors and minors. IU values and embraces people from all walks of life and is committed to the academic success of each student.

Intel Corporation recently named IU as the nation's "Most Unwired College Campus" indicating the freedom to wirelessly access the Internet. *Money Magazine's* "Five Star Places" were Bloomington, New York, San Francisco, San Diego and Austin, Texas. *Time Magazine* named IU "College of the Year" in 2001.

Bloomington, IN • 812.855.4848 • www.indiana.edu



Kelley School of Business Program

The Kelley School of Business is proud of its consistent rankings in the Top 10 in all major business disciplines. It is also the home of the Kelley Scholars and the Mitte Scholars, the nation's premier undergraduate business scholarship programs.

It offers an outstanding curriculum with skill-based courses featuring the incomparable Integrated Core (I-Core) and one-on-one tutoring services for class presentations and writing assignments.

Add world-class career services with customized counseling, internships, a terrific job placement record, and a vast network of alumni support, and you have the prescription for exceptional opportunity.

The Kelley School of Business has an Uncommon Spirit, a Worldwide Reach, and a Small-School Touch.

INDIANA UNIVERSITY

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Postmaster: Send address changes to BusinessWeek, P.O. Box 53235, Boulder, CO. 80322-3235.

Advertisement

Varacallo, et al. v. Massachusetts Mutual Life Insurance Company, et al., Civil Action No. 04-2702 (JLL)

(United States District Court for the District of New Jersey)

CLASS ACTION SETTLEMENT NOTICE

If you own or owned a life insurance or disability income policy issued by Massachusetts Mutual Life Insurance Company, Connecticut Mutual Life Insurance Company, C.M. Life Insurance Company, or MML Bay State Life Insurance Company (collectively "MassMutual") in the United States from January 1, 1983 until December 31, 2003 ("Class Period"), you may be covered by a proposed class action settlement.

YOUR RIGHTS MAY BE AFFECTED.

THIS NOTICE IS ONLY A SUMMARY. YOU SHOULD OBTAIN THE CLASS NOTICE AS SPECIFIED BELOW.

What Is This Case About?

This Action alleges that MassMutual made misrepresentations regarding the sale, performance, servicing and administration of life insurance and disability income policies. MassMutual denies all charges of wrongdoing.

Who Is Affected?

The Class includes everyone who has or had an ownership interest in any of the following types of Policies issued during the Class Period: (1) permanent life insurance policies (such as whole life, universal life, variable universal life and variable life); (2) disability income policies that have a delayed coverage claim; and/or (3) term life policies that have a delayed coverage and/or juvenile smoker claim. There are some exclusions from the Class. For a description of these exclusions as well as the claims being resolved and your rights under the settlement, please read the Class Notice. You may have received notices for other class action cases against MassMutual. This settlement may include those cases.

What Are the Benefits?

The Relief available depends on your type of Policy. Class Members with Permanent Life Insurance Policies must choose between General Policy Relief and Claim Review Relief for each Policy.

General Policy Relief is provided automatically. It is a Settlement Death Benefit that is effective, for a limited period, in addition to any death benefit you may already have under your Policy. The Settlement Death Benefit is payable upon MassMutual's receipt of due proof of the death within the prescribed period of the person whose life is insured under the Policy (or Alternate Measuring Life in certain circumstances). The length and amount of the Settlement Death Benefit depends on the age of the Measuring Life and the face amount of the Policy. Please read the Class Notice for a full description.

Alternatively, Class Members may elect Claim Review Relief. To make that choice, you must submit a Permanent Policy Election Form postmarked by October 25, 2004. A claim form will then be sent to you. You must submit that claim form describing why you believe you were misled or harmed by MassMutual in connection with your Permanent Policy. The relief depends upon the evidence submitted by you and MassMutual.

Claims that may be resolved through Claim Review Relief include: (1) Limited Premium Payment; (2) Performance; (3) Replacement; (4) Retirement and Investment; (5) Delayed Coverage; and (6) Juvenile Smoker. Please review the Class Notice for more information on these claims. There is also Alternative Dispute Resolution for other claims.

Class Members with Disability Income Policies may submit only a Delayed Coverage Claim. Class Members with Term Life Policies may submit only a Delayed Coverage Claim and/or, if eligible, a Juvenile Smoker Claim. Owners of these types of policies may seek only Claim Review Relief, and are not eligible for General Policy Relief. These Claims must be postmarked by November 8, 2004.

MassMutual will also make written disclosures for policies sold in the future that help to ensure that policyholders understand the Delayed Coverage and Juvenile Smoker Issues.

MassMutual also agreed to pay Class Counsel attorneys' fees and expenses up to \$58.2 million. That payment will be in addition to benefits provided to Class Members. MassMutual agreed to pay the named Plaintiffs up to \$10,000 each for their efforts in prosecuting Class Members' claims.

What Are My Options?

You May Remain in the Class and Participate in Settlement Benefits. You do not need to do anything in order to remain in the Class and participate in settlement benefits. However, if you have a Term Life or a Disability Income Policy, you will not be eligible for any monetary relief unless you seek Claim Review Relief and submit a claim form. A hearing will be held before Judge Jose L. Linares on November 22, 2004 at 10:00 a.m., at the Martin Luther King Building & United States Courthouse, 50 Walnut Street, Newark, New Jersey to determine whether to: (i) finally certify the class; (ii) finally approve the settlement as fair, reasonable and adequate; (iii) approve Class Counsel's application for attorneys' fees and expenses; (iv) approve the award to the named Plaintiffs; and (v) issue related orders. If you remain in the Class, you will be bound by all Court orders and will release your rights to any other recovery for claims resolved by this settlement.

You May Remain in the Class and Object to Any of the Terms of the Settlement. To do this, you must file a written objection with the Court and mail a copy to the attorneys for the parties as described in the Class Notice. The objection must be received by October 25, 2004.

If you submit a written objection, you (or an attorney acting for you at your own expense) may present your objection(s) at the Court hearing, if you file and serve a notice of intention to appear that is received by November 2, 2004.

You May Exclude Yourself from the Settlement, Not Participate in the Benefits of the Settlement and Not Be Bound. Your exclusion request must be mailed to the address in the Class Notice and must be postmarked by October 25, 2004 or it will not be valid.

How Do I Get More Information?

Read the Class Notice. If you have not received a Class Notice or if you need further information about the settlement and the forms of relief available, please: (1) call 1-800-242-7026, or if you use TDD/TTY, 1-877-506-4034 from Monday through Saturday from 9:00 a.m. (Eastern) through 6:00 p.m. (Eastern); or (2) write to MassMutual Class Action Information Center, P.O. Box 919, Minneapolis, MN 55440-0919. Telephone calls may be monitored.

DO NOT TELEPHONE THE COURT OR THE COURT CLERK.
Dated: June 24, 2004 Clerk of the Court

Making a Better Foreign Policy

THE OUTLINES OF A second-term domestic policy for George Bush are clear: a vision of an Ownership Society of lower taxes, more savings, and greater individual responsibility and risk-taking.

But this Presidential election, for the first time in many years, is also a contest over national security, and the shape of Bush's second-term foreign policy remains unclear. While the Republican Party convention focused on the issue of who can best lead America in its fight against terrorism, there was little mention of the military doctrine and diplomatic strategy to accomplish that task. It's time for the Bush campaign to present its second-term foreign policy to voters (page 38).

Here are some of the most important issues. In its first term, the Bush Administration rightly perceived the need to fundamentally change American foreign policy after September 11. When Islamic extremists are the enemy, not nation-states, the U. S. must act differently. But in both Afghanistan and Iraq, the Rumsfeld Doctrine of light, lethal, and fast military force left the job of destroying the enemy unfinished. The Taliban government was vanquished, but too few U. S. troops on the ground has prolonged instability, and Osama bin Laden remains at large.

In Iraq, an incredibly efficient military victory was followed by enormous managerial incompetence. The Pentagon refused the Army's advice to send twice as many soldiers to secure the peace. The result? Today Fallujah and other Iraqi cities are a magnet for fundamentalist terrorists. Under the dictator Saddam Hussein, Iraq was not a hotbed of Islamic religious terrorism, according to the 9/11 Commission. In a second term, the Bush Administration would do well to return to the Powell Doctrine of overwhelming military force.

Bush needs to move toward the Powell military doctrine

It would also do well to rethink its antipathy toward nation-building. By refusing to allow the State Dept. to implement its detailed post-Iraq War plans, the Bush Administration severely damaged the chances of attaining its own goal of turning Iraq into a

secular democratic state. So too in Afghanistan, where the Taliban are reemerging.

Finally, a second Bush Administration should reconsider its policy of unilateralism. In the end, the U. S. was forced to turn to the U.N. to legitimize its occupation in Iraq and it could have used many more allies to spread the burden of troops and cost, which it now bears alone. Unilateralism has, in the end, been a costly policy, generating anti-Americanism around the world and ultimately damaging U. S. authority.

There were significant victories against Islamic fundamentalists during the first Bush Administration. But there were major failures as well. It's time for the administration to tell the public how it plans to change its foreign policy to avoid previous pitfalls and attain its major goal of defeating terrorism.

A Work Order For Big Labor

THE SAD TRUTH IS THAT over Labor Day weekends, few Americans give much thought to labor unions. Organized labor used to play a major role in the lifeblood of the nation's economy, but now it

appears increasingly irrelevant. Andrew L. Stern, head of the dynamic 1.6 million-member Service Employees International Union, is trying to change that. His efforts to help the working poor garner a larger share of recent productivity gains are laudable. But Stern's efforts lack a larger vision of the role labor unions can play in a rapidly changing, super-competitive global economy based increasingly on knowledge, not sweat (page 80).

Big Labor needs to reinvent itself and move beyond the 19th

century industrial model of simply demanding "more" for its members if it is to gain traction in the 21st century. The sole drive for "more" has seen union members in steel, airlines, and other industries achieve their goals only to lose their jobs and much of their pensions because higher costs and lack of flexibility helped make their companies uncompetitive.

Stern is having success organizing the low-skilled, low end of the service sector among nursing home workers, hospital aides, and janitors where there is little global competition. The people who take care of our sick and elderly earn minimum-wage salaries that often leave them below the poverty line. Union efforts to get them a foothold into the middle class by winning higher wage gains and benefits would be welcome.

But true upward mobility requires training and education, and here labor unions can do much more. Teaching union members the skills they need to move up from low-end service jobs to work in the more highly paid parts of the economy should be one of Big Labor's major goals. Understanding and harnessing computers and information technologies would give workers a better chance for a better life. Unions should work toward positioning their members with the skills and education to get to where the real money is made—in the global information economy.



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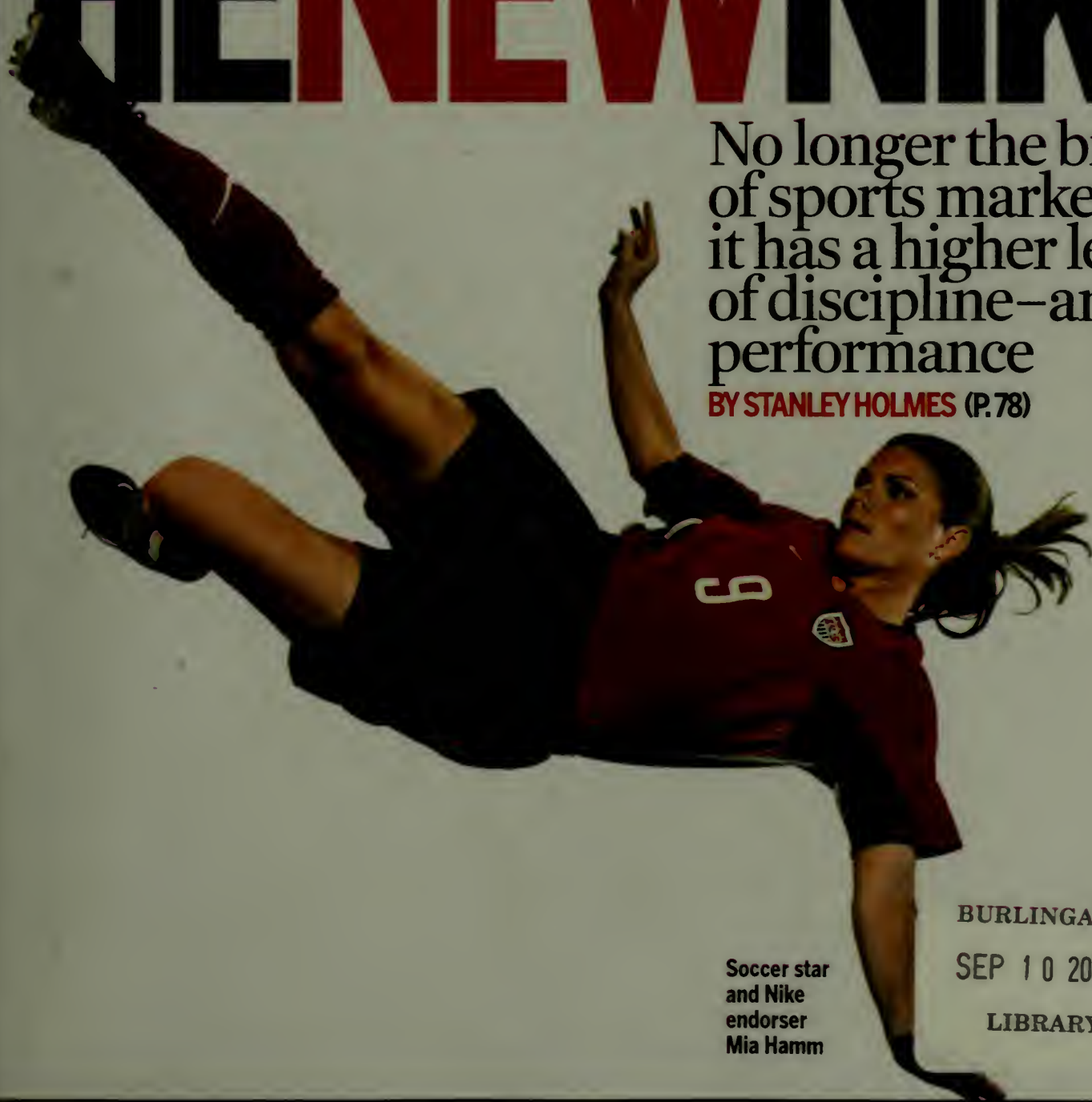
SEPTEMBER 20, 2004

www.businessweek.com

THE NEW NIKE

No longer the brat
of sports marketing,
it has a higher level
of discipline—and
performance

BY STANLEY HOLMES (P.78)



Soccer star
and Nike
endorser
Mia Hamm

BURLINGAME

SEP 10 2004

LIBRARY

**Your data takes
two sugars.**



We're inspired by the human side of data. His next big breakthrough, a masterful client presentation, even an e-mail rant on Italian coffee, are all stored as data. That's why over half of the Fortune 100 use Hitachi storage technologies to protect their data, and his opinions. From the smallest Microdrive to the largest SAN solution, Data Storage from Hitachi.

**Your data
runs a six
minute mile.**



We're inspired by the human side of data. Digital music is more than just files. It's a better mood, her personal soundtrack, or enough head-banging rock to keep her on pace. That's why high-capacity Hitachi hard disk drives are the industry choice for MP3 players, and runners alike. From the smallest Microdrive to the largest SAN solution, Data Storage from Hitachi.

hitachiyourdata.com

HITACHI
Inspire the Next

A large white sign stands in a field of tall grass. The sign has the text "Future home of TOYOTA" in a mix of script and bold sans-serif fonts, with "TOYOTA" in large red letters. Below it, "MOTOR MANUFACTURING, TEXAS" is written in a smaller sans-serif font. The background features a vast, flat landscape under a deep blue sky with scattered white clouds. In the distance, a small yellow tractor is visible on a path.

Future home of
TOYOTA
MOTOR MANUFACTURING, TEXAS

We're not just breaking new ground with our vehicles.

Toyota's eight U.S. manufacturing plants are setting the standards for building quality into every vehicle we produce. Today, eight Toyota models are manufactured in the U.S. and last year alone we built more than a million vehicles here.*

Since we first began doing business in America, Toyota has been committed to reinvesting into the local economy. Through manufacturing, sales and marketing, research and design facilities, as well as our purchasing from local suppliers, we're creating jobs and opportunities in communities across America. And with new plants under construction in San Antonio, Texas and Jackson, Tennessee, we'll continue to break new ground every day.

*Toyota components and vehicles are made using many U.S. sourced parts. ©2004



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ALL BUSINESS?

Nike may not be the rebel it was, but Serena Williams' edgy outfits at the U.S. Open sure won lots of ink

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Technology Special Report: The Future of Retailing

With e-commerce gaining steadily, bricks-and-mortar outfits are embracing new technologies to keep shoppers spending. Plus: The RFID revolution, and using tech to squeeze every penny out of inventory

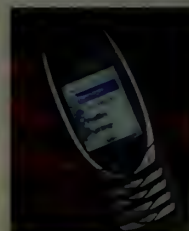


Don't Go Long on Short Skirts

An old theory insists that rising hemlines mean the bulls are charging. But with high oil prices, skyrocketing health-care costs, a sluggish job market, and the threat of terrorism hanging over the market, that old wisdom isn't holding up these days

Nokia's Goal: Building a Cell-Phone Planet

The Finnish giant is looking beyond the developed world for new growth. Its strategy for creating a ubiquitous wireless market stresses emerging countries—and rock-bottom prices



No Heat for the IT 100 in August

Despite Google's coming-out party, *BusinessWeek's* index of top tech companies had very little to cheer about as the summer wore on. Notable laggards include Intel and Oracle

Iran and Nukes: "A Tougher Nut" Than North Korea

In a two-part Q&A, Deputy Secretary of State Richard Armitage discusses the tricky choices the Bush Administration and its allies face as they try to halt the spread of nuclear weapons



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UP Front

"Bankruptcy is a real possibility."

—Gerald Grinstein, CEO of Delta Airlines, which announced up to 7,000 jobcuts and a massive restructuring plan (page 46)

EDITED BY IRA SAGER

PHONE WARS A STARTUP'S COUP COULD COST CISCO

SKYPE TECHNOLOGIES, one of the upstarts attacking the telecom industry by offering free phone calls via the Internet, has landed a big fish for its board. *BusinessWeek* has

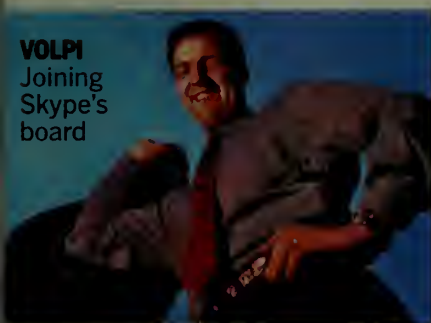
and he has great experience," says Niklas Zennstrom, a co-founder of Skype, which has grown to 10 million users in just a year. Skype hopes that Volpi's industry contacts will help it land deals in Asia.

That's great news for Skype, but it could raise delicate questions for Cisco. In the 1990s, it teamed with a generation of now-defunct Net startups that wanted to

attack the phone business. Ever since, Cisco has been working to win back the trust of Baby Bells and other local phone companies. It doesn't help that Skype's founders also created **KaZaA**, the music file-sharing site that has drawn the ire of the

recording industry.

Cisco says Volpi made a personal decision to join Skype, which it O.K.'d. The company says it has no plans to make an investment. —Alex Salkever, with Peter Burrows



VOLPI
Joining Skype's board

learned that Mike Volpi, a senior vice-president at networking giant **Cisco Systems**, has become the Luxembourg company's first outside director. "[Volpi] shares the same vision for the future as we do,



WHEELS

Carmakers Put On the Squeeze

IT SEEMS SOME of J.D. Power & Associates' auto clients have been complaining that the research company's data are too often used to write negative stories. So on Sept. 7, the Westlake Village (Calif.) company—long the ultimate arbiter of car quality in large part by supplying hard-to-get information to auto industry reporters—said it's turning down the data spigot.

The company will still grind out surveys and studies ranking brands and models based on consumer complaints. But it will restrict how its Power Information Network, which offers far more detailed data on vehicle purchasing, shares information with the media. While willing to give out general numbers on minivan sales, for instance, it will no longer reveal how many minivan buyers **General Motors** lost last year to Korean brands. Nor will it say how many **Ford** owners defected to **Toyota** or even the average age of Buick buyers.

Power spokesman Peter Marlow concedes that clients haven't been happy to see some data in print. "Everything we publish gets pushback from our clients, except from the 10% who score the highest," he says. Power's solution is simple: Shoot the messenger.

—David Kiley

THE BIG PICTURE

LAWSUIT PIPELINE There's an estimated \$5.5 billion in unsettled securities class actions. Some of the largest pending settlements:

WORLDWIDE/CITIGROUP MILLIONS OF DOLLARS (EST.)

\$2,650

GLOBAL CROSSING

\$245

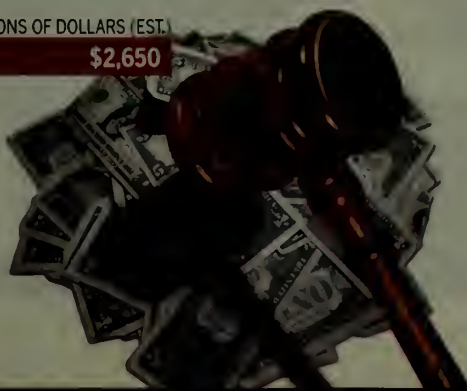
SYMBOL TECHNOLOGIES

\$102

HONEYWELL INTERNATIONAL

\$100

Data: Institutional Shareholder Services



LABOR NOTES

HISPANICS LEARN TO CRY FOUL

WORKPLACE COMPLAINTS from Hispanics are up 22% since 1999, says the **Equal Employment Opportunity Commission**. And the allegations include harassment, unfair pay, and



"English only" rules at companies such as **InterContinental Hotel Group's Holiday Inn Express** and **LVMH Group's Sephora USA**. Sephora denies the charges, while Holiday Inn Express settled its case.

BASTA! Workers are organizing

In part, the rise in complaints is a by-product of more Hispanics in the workforce. Tensions have grown in industries such as manufacturing and construction. There, some co-workers are angry that Hispanics, many recent immigrants, take less pay, displacing white and black workers and holding down wages. Also, Hispanics are now taking jobs in locales such as Georgia and Iowa, where outside labor competition has been rare.

The EEOC has also made efforts to educate Hispanic workers, including illegal immigrants who don't always know they can file complaints despite their undocumented status. U.S. Hispanics, now topping 42 million, are feeling newly empowered to say *basta* to workplace discrimination. —Brian Grow

CAR TALK

CARTOONS, that's how Toyota is courting Gen Y. It asked ad agency Saatchi & Saatchi to create an 18-page comic book for the sporty Celica. Titled *Fuel*, it tells of Celica GT-S owner Max and his showdown against drag-race champ Slam. Unlike BMW's New Yorker comic insert to push the Mini, **Toyota's "target is predominantly males 18 to 25 interested in enhancing their cars,"** says Steve Rabosky, Saatchi's chief creative officer. The comic nods to the fast-growing aftermarket business with info on features such as alloy rims and racing pedals. If *Fuel* is a hit, Max may be in for a rematch. —Chester Dawson



HEALTH CARE

IF IT'S GOOD ENOUGH FOR ROVER...

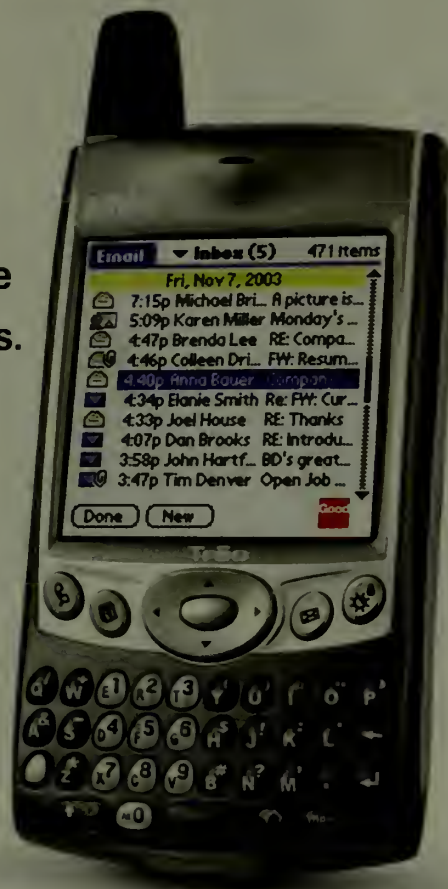
FOUR COMPANIES WERE outed last week for not insuring employees' domestic partners —though they did offer to insure pets. The **Human Rights Campaign**, a gay advocacy group, cited **Home Depot**, **Sprint**, **Waste Management**, and **Ecolab**. Home Depot says it will extend benefits to same-sex partners in October. The others are considering it.

Overall, humans still fare better than animals: 34% of companies now offer same-sex domestic partners benefits, says the **Society for Human Resource Management**. Just 3% of companies insure pets. —Brian Grow

DRAWN & QUARTERED



Suddenly the idea of email on a cell phone
seems obvious.



Treo 600

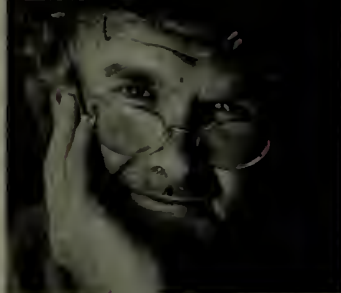
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FACE TIME

**HARTMUT
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FROG WENT A-SELLIN'

Since founding frog design in 1969, German-born **Hartmut Esslinger** has injected European style into Silicon Valley's geeky aesthetic. His 170-person, Sunnyvale (Calif.) firm designed Apple Computer's first Macintosh and updated Dell's e-commerce Web site, while Esslinger fashioned a larger-than-life persona, even appearing on *BusinessWeek*'s cover in motorcycle leathers.

Now 60, he has cashed in. Last month, he and his wife, co-CEO Patricia Roller, sold a majority stake in frog to contract manufacturer Flextronics International for more than \$20 million, say sources. Flex can now take a job start-to-finish, designing not only the electronic guts, but also the look and feel of products.

The alliance could lead to "personalized production," says Esslinger. Rather than buy a pre-stocked model, you could cobble together an ideal product—say, a cellphone with larger keys for Mom. So don't look for Esslinger to ride off into the sunset. When the time comes, "it won't be on a horse," the sports car aficionado says. "A Porsche, maybe." —Peter Burrows

SPACE INVADERS

WHERE NO WEBCAM HAS GONE BEFORE

FOR ASTRONOMY BUFFS, taking pictures of planets, nebulae, and other deep-sky objects can be expensive. Astronomy cameras start at \$1,500 and can reach \$5,000. But there's a cheaper way to wish upon a star: tinkering with Webcams. Following instructions freely available on the Internet, enthusiasts have modified common \$99 Webcams made by **Logitech International** and **Philips** to capture surprisingly impressive images of planets and stars.

Here's how it's done. Using Webcams with "charge-coupled device" (CCD) chips, which are especially sensitive to light, stargazers can simply remove the lens to shoot bright subjects such as the moon and nearby planets. More distant nebulae and galaxies require longer exposure times, and more fiddling. Do-



SEEING STARS Webcams (insert) can't match Hubble images, but they're not bad

it-yourselfers manually solder tiny circuits in the Webcam to block the signal that ends the exposure. Then they clean up the image with special software.

Too much grunt work? Companies such as Melbourne (Fla.)-based **SAC Imaging Systems** and Portugal's **Perseu** sell already-modified Webcams to those less eager to do the handiwork themselves. SAC President William Snyder

expects sales of his cameras, which sell for around \$250 on average, to double this year to \$500,000. Perseu reports similar numbers.

Bigger players are catching on, too. Venerable **Meade Instruments**, a maker of high-end astronomy gear, will roll out a \$299 CCD-based camera by October. "[It was] an untapped market," says Ken Baun, Meade's vice-president for engineering. Not quite the Hubble Space Telescope, but, at a couple billion dollars cheaper, it's quite a bargain.

—Susan Zege

GENDER WATCH

SHE STOPS SHOPPING TO CONQUER

IF WOMEN shut their purses and didn't shop for a day, would the economy suffer?

The idea gets tested on Oct. 19 by **85 Broads**, a networking group founded in 1999 by Janet Hanson, who worked for **Goldman Sachs**—headquartered at 85 Broad St.

BusinessWeek has learned that 85

Broads is asking its 4,000-plus members in 450 companies, colleges, and B-schools not to spend that day. Hanson says the "buycott" will show the gap between women's purchasing power and their underrepresentation in boardrooms and executive suites. Members



"BUYCOTT" A no-purchase Oct. 19

plan to spread the word to friends and to women on college campuses. Women control \$3.3 trillion in yearly consumer spending, 44% of national spending—a sum that isn't just symbolic.

—Emily Thornton

THE STAT

29

The percentage of teenagers who say that one has to "bend the rules to succeed" in business. Only 20% of teens said the same thing last year.

Data: Junior Achievement, Deloitte & Touche, SA

A tiny camera lens* has been placed above the rear license plate of the RX 330, transmitting a full-color image to the accompanying NAV screen of whatever lies behind you as you back up – be it a bicycle, a potted plant or another car's bumper. A feature that can prove especially valuable when parallel parking. The backup camera system joins Dynamic Laser Cruise Control and a host of other technological wonders as available features in the RX. A vehicle that is a natural result of our daily pursuit of perfection. **THE RX 330**

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CELEBRATING



As part of its anniversary celebration, BusinessWeek is presenting a series of weekly profiles of the greatest innovators of the past 75 years. Some made their mark in science or technology; others in management, finance, marketing, or government. In late September, 2004, BusinessWeek will publish a special commemorative issue on Innovation.

No Overnight Success

FREDERICK W. SMITH, founder of FedEx Corp., has transportation in his blood. His grandfather was a steamboat captain, and his father built from scratch a regional bus line that became the Southern backbone of the Greyhound Bus system. Smith learned to fly as a teenager, a skill he turned to cash by

working weekends as a charter pilot during his years as a student at Yale University in the 1960s.

While flying students and other passengers around, Smith had the insight that led him to revolutionize the delivery business. He noticed that he was also frequently ferrying spare parts for computer companies such as IBM that didn't want to wait for the passenger airlines to get critical components to customers.

Smith, an economics major, first broached his idea for an express delivery service in 1965 in what became one of the most infamous term papers in Corporate America. Lore has it that he received a modest C, though Smith doesn't think that was the case. Whatever the grade, he wasn't deterred. "I knew the idea was profound," he says.

After a hitch with the Marines in Vietnam, Smith returned in the late '60s and began to chase his dream. He soon found backers with more faith in his ideas than his professors. With \$4 million inherited from his father and \$80 million from venture capitalists, he set up Federal Express Corp. in 1971. Its promise: guaranteed overnight delivery of critical goods between any two points in the 11-city network Smith created.

Unique, but hardly an overnight success. Ready to launch the service from Memphis on Mar. 12, 1973, Smith secured just seven packages for the first night's run. He sent his salesmen back into the field, more than doubled his network to 25 cities, and relaunched the service a month later—this time handling a grand total of 186 packages.

Sparse initial volume wasn't the only headache. Until the

Frederick Smith's FedEx sparked a revolution in just-in-time delivery

late '70s, the postal monopoly stopped FedEx from delivering documents. Onerous airline regulations at first restricted it to flying tiny Falcon jets. By 1973, Smith was so desperate for cash that he flew to Las Vegas to play the blackjack tables. He wired the \$27,000 he won back to FedEx.

Smith's persistence paid off. By the late 1970s, America came to rely on FedEx' ability to deliver goods overnight—be it spare parts, urgent business documents, or 11th-hour birthday gifts. Merrill Lynch & Co. execs even discovered employees were using FedEx to deliver documents between floors of its Manhattan headquarters building because it was faster and more reliable than the interoffice mail. These days, FedEx is a linchpin of the just-in-time deliveries revolution—its planes and trucks serving as mobile warehouses—that has helped companies around the globe cut costs and boost their productivity. The logistics service now contributes the lion's share—92%—of FedEx' \$26 billion in annual revenues.

Although FedEx has spawned numerous competitors, it is still the biggest operator, with a 44% share of the air express market. Its fleet of 645 aircraft and 71,000 trucks carry an average of 5.5 million shipments each day. And all because a college kid could see a market that others couldn't. ■

—By Dean Fous

BusinessWeek online For a Q&A with FedEx CEO Frederick Smith, go to www.businessweek.com/magazine/extra.htm



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IN MEMORIAM: DAVID FAIRLAMB 1951-2004



David was known for his highly analytic and nuanced coverage of the European banking world, which he followed for 25 years. He was a passionate believer in a modern Europe. His

BusinessWeek has lost one of its most gifted and prolific writers. David Fairlamb, European economics correspondent, died on Sept. 1 in Reykjavik, after falling ill while traveling in Iceland.

last article, in the Aug. 9 issue, argued that Europe's failure to exploit technology was slowing productivity gains.

David, who spoke six languages, also covered Eastern Europe—most recently when Poland joined the EU in May. Although based in Frankfurt, he spent most weekends either in Britain, where his six children live, or in Moscow, home of his second wife, Irina Nikolskaya. We extend our deepest condolences to David's family and his many friends.

JUST WHAT IS THE EXECUTIVE LIFE?

"THE EXECUTIVE LIFE" (Special Report, Aug. 23-30) has a lot of fun-to-read articles, and I'm a regular American who likes all those things. But I think you missed an important part of the executive life. It affords us the work experience, connections, and financial resources to be active participants in the philanthropic causes we find most compelling. That is the best benefit of all.

—Christine Owens
Superior, Colo.

I DO NOT DOUBT the stress of executive positions, but there are countless people working long days at stressful jobs for annual salaries that would buy just a week or two at one of your recommended getaways. You might better address the impact of slashed retirement plans or examine alternative jobs for skilled workers who are suddenly unemployed at age 50.

—Sally McKeever
Hershey, Pa.

IN THE FALL OF 1996, *BusinessWeek* featured an article on the newly designed Corvette, the C-5. I put one in my garage

in 1997. When your current issue arrived, I quickly flipped to "Cars to Love," expecting to see some fancy import, but WHOA! a double-page, sixth-generation red Corvette. The fall debut is just around the corner. And so is my birthday.

—Susan Darnall
Chicago

SAFEGUARDING YOUR HEALTH

THE FREQUENCIES recommended in "Checkup checklist" seemed a bit liberal ("The executive life: Health, Aug. 23-30"). For example, with the aggressive strains of HPV, a pap smear every three years seems like an incredibly long stretch. At 26, I went from completely healthy to carcinoma in situ in less than seven months. Had I been on a three-year schedule, it would have most likely been invasive and spread before it was ever noticed. I cannot speak to the other tests, but I would urge everyone, regardless of their perceived risks, to check with their physicians about the necessary frequency of these checkups.

—Stacy Robin
West Orange, N.J.

EXCEPT FOR THE SUBHEAD "You can

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"HENDRICK'S" WON

THE GIN CATEGORY...

- THE WALL STREET JOURNAL

THE WALL STREET JOURNAL

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FRIDAY, AUGUST 29, 2003 - VOL. CXXIII NO. 41 - ***** \$1.00

When it came to our tasting of "white goods," the superpremiums ruled the day. Here, our top three in each category, plus our tasters' comments:

LIQUOR BRAND/PRICE* OUR AWARD

TOP 3 GINS

Hendrick's \$30/750ml	Most Flavorful
--------------------------	-------------------

Tanqueray No. Ten \$26/750ml	Smoothest
---------------------------------	-----------

Juniper Green Organic \$26.50/750ml	Best Presentation
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Readers Report

CORRECTIONS & CLARIFICATIONS

In "PSS is really delivering the goods" (Inside Wall Street, Aug. 23-30), the \$160 million sales figure cited was actually sales in 1994, when PSS World Medical went public.

get most of what you need by eating right. Beyond that, be cautious," John Carey's otherwise informative and balanced story on "Vitamins" would have missed out on valuable nutrition information. For example, they wouldn't have learned about the recommendation to take a multivitamin, or the benefits of B vitamins in preventing birth defects and heart disease, or the critical need for more vitamin D.

And although we wholeheartedly support the goal of nine servings of fruits and vegetables each day, reality suggests that, despite everyone's best efforts, Americans still fall short of the ideal diet. Vitamins and other dietary supplements have an important role to play in preventing disease and promoting good health.

-Annette Dickinson, President
Council for Responsible Nutrition
Washington

Editor's Note: The Council represents the dietary-supplement industry.

I FOUND MUCH OF "The Executive Life" very interesting. "Fitness" states that a home workout means no waiting. I have been doing the same exercise routine twice a week since September, 1977, and the only way I could fit it into my schedule is by doing it at home. From the time my alarm clock goes off, I am beginning my workout. I finish 32 minutes after I start. By the way, equipment does not need to cost \$5,500. I bought my weights from a friend 35 years ago for \$5 and the bench from Target for \$19. My running shoes cost \$160.

-Rick Roome
Simi Valley, Calif.

BROKERS OR ADVISERS? THE PLOT THICKENS

AMY BORRUS' "Brokers aren't advisers" (News: Analysis & Commentary, Aug. 23-30) was a great story, and the problems are larger and deeper than she indicated. Almost every single broker-dealer firm requires clients to sign mandatory National Association of Securities Dealers arbitration agreements. The standard that the NASD holds brokers to is suitability. NASD arbitration is final, the only legal recourse for clients. A second problem is with a bro-

ker who is a certified financial planner (CFP). This group has codes of conduct and ethical requirements, one of which is that the CFP practitioner is a fiduciary. Brokers who are CFPs hold themselves out as fiduciaries, but when push comes to shove, the only legal standard they are held to is suitability. I would suggest that the CFP Board of Standards is playing both sides. One cannot be a fiduciary if they cannot be legally held to the standard.

-Scott Leonard
Redondo Beach, Calif.

TAXES: AN INVESTMENT IN OUR NATION

THERE IS A SERIOUS misunderstanding about the role of taxation in "Sizing up John Kerry's battle plan," (Readers Report, Aug. 23-30). A reader states: "It's not the government's money—it's your money. Let's not forget that." Taxes pay for national security; for things such as clean air and water; for education and arts; for science and infrastructure; and for the safety to enjoy them. In times of natural disasters and hardship, taxes help those in desperate need. Taxes are just not something we pay. They are an investment we are required to make. The return is tremendous. Taxes are the dues we pay as members of the greatest club in the world. "Your money" does not exist in a vacuum. It is part of the nation's economy.

People were taxed for thousands of years before this republic was born. Our founders added the important element of "no taxation without representation." This simple principle speaks of the democratic ideal in economic terms. Fair taxation is honest. Paying fairly is patriotic. To the letter from that reader, I respond: It's not your *money's* government; it's *your* government. For an Administration to offer representation without taxation, whether to wealthy individuals, business, or churches, runs contrary to the foundation of American democracy.

-Paul Volker
Columbus, Ohio

Editor's note: The writer is not related to the former Federal Reserve chairman.

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What Will Rise at Ground Zero?

UP FROM ZERO Politics, Architecture, and the Rebuilding of New York
By Paul Goldberger; Random House; 273pp; \$24.95

For most of us grappling with the enormity of September 11, the question of what should arise where the World Trade Center once stood had a simple answer: We wanted something big, something beautiful, and something that would reflect the vibrancy of New York while still respecting the nation's

memories of that fateful day. Now that a master plan for Ground Zero has been adopted, designs chosen for its memorial and transit hub, and symbolic ground broken for its signature skyscraper, the Freedom Tower, those desires could actually come to pass.

But don't count on it. In his deftly written narrative of this massive project, *Up from Zero: Politics, Architecture, and the Rebuilding of New York*, Paul Goldberger warns that the public may not get what it wants. What happens at Ground Zero will have as much to do with the wishes of dealmaking politicians, revenue-hungry bureaucrats, and entrepreneurial-minded developers as with the taste and desires of the populace. And that's true even for a populace that took the time to educate itself and make its voice heard in innumerable ways in the aftermath of the Trade Center's destruction.

As you would expect from the architecture critic for *The New Yorker* and formerly for *The New York Times*, Goldberger devotes much of his book to an evaluation of the plans of the architects who hoped to put their stamp on Ground Zero. The presence of such luminaries as Daniel Libeskind—who won the competition for the design—Rafael Viñoly, Norman Foster, and Santiago Calatrava, among others, may have marked a high point in New York's design history. In a city where aesthetics usually takes a backseat to commerce, the intense interest of politicians, businesspeople, civic activists, and ordinary citizens helped ensure—at least for a while—that “architecture was given a seat at the table that it had never before had,” writes Goldberger. The author details many of the symposiums, exhibits, and town meetings that took place after September 11, as New Yorkers struggled to figure out the next step for the sadly empty 16 acres a few blocks from Wall Street. Should the area contain a replica of the Twin Towers? How about a community in the Jane Jacobs mode, with a lively mix of offices, stores, and apartments? Or, as the final resting place of thousands, maybe it should contain nothing at all?

But with the stakes so high, it seems that art was in no

position to trump commerce. At best, Goldberger believes, the two have come to a draw. He reminds us that the Port Authority of New York & New Jersey, the agency that owned the Trade Center, and the Lower Manhattan Development Corp., the New York State unit founded to oversee rebuilding, never promised that any of the wonderful designs paraded before the public in 2002 would actually be built. Out of what was dubbed the Innovative Design Study, the authorities really wanted only a master plan—a layout of where skyscrapers and other elements would go. Crucially, that plan was driven by the Port Authority's need to recreate 10 million square feet of office space lost in the attacks. And the Trade Center's leaseholder, Larry Silverstein, is still on the hook for \$120 million in annual rent.

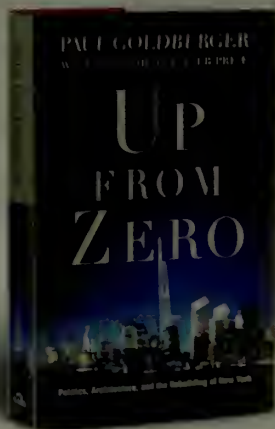
Through some crafty political maneuvering, Silverstein's own architect, David Childs, ended up modifying Libeskind's design of the Freedom Tower in a bid to make it more commercial—so much so that it scarcely resembles the proposed building that dazzled the world two years ago. “As a complete work of design, the Freedom Tower had all the defects of an unnatural hybrid,” writes Goldberger, who holds Libeskind's original in high regard. “It is certainly not a retrograde piece of aesthetics, but it hardly seems to break the new ground that was hoped for, either.” Meanwhile, in a development subsequent to the book's completion, relations between Silverstein and Libeskind have fallen so low that Libeskind has sued for \$843,750 that he claims he is owed for design work.

Although the entire site will probably not be built out for decades, Goldberger leaves us with a fairly depressing picture so far—of mediocre design and lackluster urban planning. But nobody knows what the effect will be when construction is finished. Even Goldberger admits that the Twin Towers, unloved and nearly empty at first, wormed their way into New Yorkers' hearts. The dramatic Windows on the World restaurant, the *King Kong* remake

Goldberger is disheartened by mediocre design and retrograde planning

that featured the buildings, and daredevil Philippe Petit, who walked a tightrope between the towers, all helped to humanize a work originally perceived as cold, monumental, and out-of-step with the city's traditional architecture. Perhaps the lesson here, which Goldberger only hints at, is that what makes a building memorable and important are the uses—silly or sublime—and the feelings that people finally attach to whatever gets built. And that is something yet to be seen. ■

—By Robert McNatt





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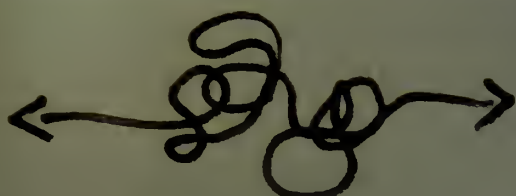
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A. BEFORE BROWN



B. AFTER BROWN



BY STEPHEN H. WILDSTROM

BlackBerry: Born Again For the Mass Market

Research in Motion started a revolution five years ago when it rolled out the first BlackBerry wireless e-mail device. The BlackBerry keyboard seemed too small to be usable, until you tried it. Thumb-typing became trendy, and truly mobile e-mail was born. Now, RIM, in Waterloo, Ont., has reinvented the BlackBerry, and it's a winner.

The BlackBerry 7100t, which will be available from T-Mobile USA in about a month, addresses the two issues that have kept wireless e-mail devices from becoming true mass-market products. At \$199, it will be \$150 cheaper than the current BlackBerry 7200 series and \$250 less than the rival palmOne Treo 600. Equally important, it looks, feels, and acts more like a phone than any previous BlackBerry.

Until now, the keyboard has kept these products relatively big. The Treo has been the most phone-like, and the 2¼-inch width of its keyboard seemed to take the design as far as it could go and maybe a bit further. But the new BlackBerry's keyboard is just 1½ in. wide, and that three-eighths of an inch makes a big difference. At the same time, the keys are closer to the size of those on a standard wireless phone than are Treo's tiny buttons.

The key to this seeming paradox is the novel design of the BlackBerry keyboard. It uses a standard "qwerty" layout, but most of the keys produce two letters; for example, "q" and "w" share a key, as do "e" and "r." This gets the entire alphabet onto just 14 keys. But unlike a phone dial pad, where you select one letter out of three by tapping a key repeatedly, the BlackBerry works some algorithmic magic.

SIMPLY PUT, THE BLACKBERRY IS SMART ENOUGH to figure out which of the two letters you want and get it right nearly all the time. Prediction of this sort has been used before, particularly the T9 software from Tegic Communications, but it has never worked well. The BlackBerry has several huge advantages. With an average of 1.85 letters per key rather than the 3.25 on a standard phone, its odds of guessing right are much better. It improves the odds further by adding frequently used words to the phone's dictionary as well as all the names in your contact list. This last step overcomes the

biggest shortfall of prediction, the tendency to mangle proper nouns. The BlackBerry is even smart enough to capitalize names automatically.

The trick to typing on the BlackBerry is to avoid the temptation to correct it until you have completed a word, because it makes mistakes and then fixes them. For example, as I typed the word "present," it got the "p" right, but then guessed "or," "per," and "ores." After I pressed the e-r key for the second "e," it caught my drift and completed the word correctly. RIM advises not looking at the display while typing, but watching the on-the-fly correction is fascinating. Just hold off on fixing anything until the word is finished, and it will almost always come out right—provided you are writing in English.

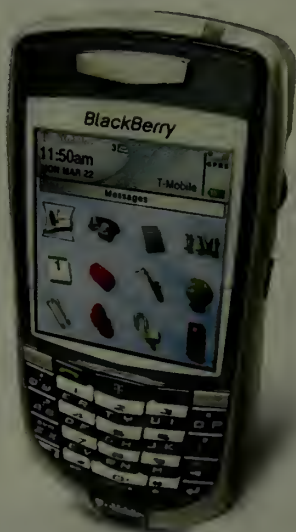
The new version costs just \$199—and is more like a phone

The 7100t is the first BlackBerry that is also a first-rate phone. Pressing the green "call" button automatically brings up the dialing screen from any

application, and the 12 buttons down the middle of the keyboard become a standard dial pad. You can also dial directly from your contact list or set up single-key speed dials.

Despite its appearance and low price, the 7100t is a full-fledged BlackBerry and can send and receive standard Internet mail as well as missives from behind-the-firewall corporate accounts. It includes a decent Web browser and can run customized applications. Although all major U.S. wireless carriers currently offer BlackBerrys, for now the new model will initially be available exclusively from T-Mobile. The service costs \$60 a month for 1,000 voice minutes and unlimited data. Between attractive pricing and clever design, the BlackBerry could be ready for the jump from executive toy to mass-market must-have. ■

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BY GLENN HUBBARD

A Prescription for Health-Care Reform

An "Ownership Society" agenda has taken center stage in President George W. Bush's agenda for a second term, with proposals for Personal Accounts in Social Security, expanded incentives to save for retirement, and Personal Reemployment Accounts to aid workers in finding a new job. But a central plank of this agenda, and one that can be enhanced to improve markets

for health care, is already law: the Health Savings Accounts (HSAs) passed in the recent Medicare reform.

HSAs, which let individuals set up tax-preferred accounts to pay for health care—so long as they buy high-deductible health insurance—allow citizens, as the President says, to "own their own health care." Under current law, people can use pretax dollars to fund a deductible of at least \$2,000 for a family and insurance pays expenses above that amount. HSAs can also shore up troubled Medicare and mimic the economic advantage of the Social Security Personal Accounts.

HSAs help make health-care markets work better by removing the tax bias toward third-party payments.

PATIENT-CENTERED HEALTH CARE is a hard concept to implement when direct patient payments make up only \$1 out of every \$6 of expenditures. With insurers paying for even routine care, consumers lack incentives to shop for low-cost, high-value care. Middle-income families receive a huge tax discount by buying employer-sponsored insurance: A household earning \$50,000 gets a subsidy equal to its combined marginal income and payroll tax rate of about 40%.

In the short run, markets cope with this situation by shifting and managing costs. Small employers will probably drop coverage. In the long run, the problems will lead to calls for more government intervention—bringing price controls and a system responding slowly to innovation.

But a simple change can improve HSAs as a tool of health policy and the Ownership Society: Let all Americans deduct expenditures on insurance and out-of-pocket expenses as long as they purchase at least insurance against catastrophes. That is, people already covered by employer plans could deduct out-of-pocket expenses. The self-employed with insurance may deduct out-of-pocket expenses. Those now without coverage may deduct both insurance premiums and out-of-pocket expenses if they purchase an individual plan.

The change would level the playing field between medical care through employer insurance and direct out-of-pocket outlays. Acquiring insurance would be encouraged since the tax break is available only with insurance. Importantly, the tax-code bias for high-cost, low-deductible insurance would be removed, allowing for deductibility of out-of-pocket expenses.

The tax change reduces the bias against buying insurance on your own, either through your employer or individually.

Such an enhancement of HSAs raises two policy questions. First, as expanded HSAs make individual coverage more attractive, would employer-based insurance unravel? No. Expanded HSAs just remove much of the difference between buying insurance through one's employer or on one's own.

Second, by making more out-of-pocket outlays deductible, wouldn't an enhanced HSA raise costs? No. People will shift to plans with higher deductibles and co-insurance, reducing health-care utilization. John F. Cogan, Daniel P. Kessler, and I have estimated the net decline in spending at more than \$65 billion a year. That drop is achievable without price controls.

Routine bills should be deductible—if people are insured for catastrophes

But resources no longer spent on health would flow to other, taxable activities: Wages will climb by the amount of the decline in employer premium payments. Besides putting cash in workers' pockets, new income and payroll tax collections will rise enough to cover much of the revenue loss from tax deductibility. HSAs also offer a vehicle through which health assistance to low-income households could be distributed, helping families buy insurance in

private markets and save for old-age medical expenses.

Finally, HSAs, and the ownership agenda they represent, are a stark contrast to the vision offered by John F. Kerry. The Kerry plan would spend \$1 trillion over 10 years, expanding government's role in health care. This requires more than the tax increase on high-income earners that Kerry has outlined. And carrying the debate to shoring up Medicare, the Senator's "solve it with tax increases" theme bodes ill for growth, and does little to put the consumer in the driver's seat.

To the patient and voter: Read the prescriptions carefully. ■

Glenn Hubbard is dean of Columbia Business School. He chaired the Council of Economic Advisers from February, 2001, to March, 2003, and remains an informal White House adviser.

BY JAMES C. COOPER & KATHLEEN MADIGAN

The National Piggy Bank Is Going Hungry

A low savings rate threatens boomers' retirement—and long-term growth

U.S. ECONOMY

Americans don't save enough. You hear this warning all the time. In July, the savings rate of households fell to 0.6% of aftertax income, very close to an all-time low. But while most of the concern tends to focus on the short-term problem that skimpy savings could create for the sustainability of economic growth, it's the

long-term problem that's potentially the most alarming.

Worries about a dearth of household savings have come and gone in early stages of past recoveries: Heavily indebted households, without much of a nest egg, put consumer spending at risk, especially if job growth falters. This time, it hasn't worked out that way, partly because a recovering stock market and rising home prices have boosted household wealth even faster than debt, offsetting some of these near-term concerns.

The August pickup in payrolls also should help allay some short-term worries. The Labor Dept. said jobs increased by 144,000 last month, and the gains in both June and July, while still tepid, were at least revised up a bit. The implication is that growth in consumer spending—and the economy—is rebounding after the second-quarter slowdown.

But in the long run, the urgency of the savings challenge stems from a basic economic fact of life: Investment, the life blood of future growth, is limited by the savings available to finance it. And it's not just the unwillingness or inability of households to sock more money away. It's also that the federal government is siphoning off a big chunk of domestic savings to fund enormous budget deficits (chart).

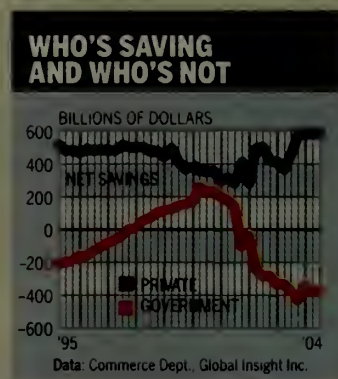
THE GREAT SAVINGS DEBATE is already heating up, and it's easy to see why. The first baby boomers are only a few steps away from retirement, and the over-65 population will nearly double in the next 30 years. The coming pressure on the Social Security and Medicare systems—and the associated demands on Washington's fiscal situation—is too enormous to ignore any longer.

The Bush Administration is considering a host of schemes aimed at boosting savings, including tax incentives, raising the limits on individual retirement accounts, and expanding savings accounts for health-care expenses. Presidential candidate Senator John F. Kerry is proposing a plan that would help small businesses cut the administrative costs of setting up pension and other savings plans. And Federal Reserve Chairman Alan Greenspan recently weighed in with a call for more savings, noting its crucial role in helping the U.S. in the future to deal with its aging population.

Savings available for investment can be homegrown in the U.S. or borrowed from abroad. And there's the rub. In the second quarter of 2004, net domestic investment, which excludes outlays to replace depreciated equipment and buildings, totaled \$922 billion. But less than one-third was financed with net domestic savings. The greater share, more than two-thirds, was made possible by net

borrowings from overseas lenders.

That borrowing is roughly equivalent to the U.S. current account deficit, which comprises mainly the trade deficit, net investment income the U.S. owes to foreigners, and certain transfer payments. The Commerce Dept. will report the second-quarter current account gap on



Sept. 14, and it's widely expected to hit a record 5.5% of gross domestic product.

This reliance means that, without more homegrown savings, the U.S. could get into a real bind. As Greenspan said in his speech at Jackson Hole, Wyo., on Aug. 27, "it is difficult to imagine that we can continue indefinitely to borrow saving from abroad at a rate equivalent to 5% of U.S. gross domestic product."

WHAT HAPPENS IF those foreign funds become less plentiful? Then the pressure to finance U.S. investment falls increasingly onto domestic savings. The track record in recent years is not good, but it would be wrong to put the blame totally on a lack of saving by the private sector.

In fact, during the past four years, net savings by households and businesses has increased by \$234 billion, to \$588 billion in the second quarter. Household savings has declined by \$67 billion, to \$104 billion, but savings by the business sector shot up by \$301 billion, to \$484 billion, as corporations' retained earnings have jumped along with the powerful recovery in cash flow.

Over the same period, however, savings by federal,

state, and local governments swung from \$241 billion to a negative \$366 billion, reflecting a reversal of nearly \$600 billion in the federal budget balance. As a result, despite the gain in private savings, overall net national savings have fallen from \$595 billion four years ago, to \$222 billion in the second quarter. To finance last quarter's \$922 billion in net investment, foreigners ponied up the difference (chart).

The latest forecast by the nonpartisan Congressional Budget Office offers little hope for greater government savings. Based on current law, the federal deficit will shrink from \$422 billion in fiscal 2004 to \$348 billion in 2005, the CBO says. Longer-term projections, however, are not encouraging, especially if Congress does not allow the provisions in the 2003 tax bill to expire. As Greenspan told Congress on Sept. 8, "the prospects for the federal budget over the longer term remain troubling."

THE MOST IMPORTANT REASON greater domestic savings is so crucial to the future is the link between investment and productivity. Productivity gains, which boost real incomes and living standards, are the best hope to generate the economic growth needed to fund commitments to retirees without placing the U.S. in fiscal jeopardy.

Even here, the road is uncertain. Greenspan notes that about half of the decade-long surge in U.S. productivity growth reflects greater investment while the other half has come from the increased efficiency with which the U.S. has invested its savings. That is, new technologies

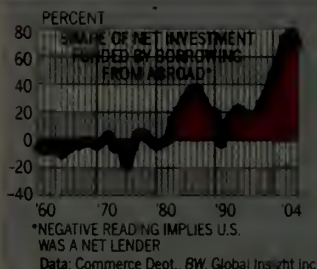
have yielded more bang for each investment buck.

But he notes that, historically, the contribution to productivity gains from additional investment dollars alone has been much larger than recently. The trouble: If the rate of technological advancement slows, it becomes more imperative that a higher level of

investment take up the slack in providing strong productivity growth. But if foreign savings become less available, the Fed chairman says, "maintaining even a lower rate of capital investment growth will likely require an increased rate of domestic saving."

Recent history offers a vivid illustration. From

A GROWING DEPENDENCE ON FOREIGN SAVINGS



1995 to 1999, the years during the investment boom, net domestic savings climbed by \$300 billion, the largest increase in the postwar era. But the biggest contributor was not households, not businesses, and not foreigners. It was a \$340 billion turnaround in the federal budget balance from a deficit to a surplus.

The lesson for the economy's future health is clear: If Washington is intent on looking for ways to bolster household and business savings, it should consider cleaning up its own house as well. ■

SOUTHEAST ASIA

Higher Oil Prices, Lower Output

SOUTHEAST ASIA has benefited greatly from the global economic upturn. A rebound in business spending worldwide had boosted the region's level of exports and helped domestic demand. But this year's surging oil prices, which are slowing global expansion and upping production costs, are starting to put a brake on the region's growth.

The different economies are still doing well, but some effects from oil prices are emerging. In Thailand, second-quarter real gross domestic product eased to an annualized pace of 6.3%, after peaking at 7.8% in the last period of 2003. Growth was slowed by oil prices and an avian flu outbreak. The still-

high level of oil prices led the government to cut its 2005 growth estimate to a range of 5.5% to 6.5%, from an earlier 7.5%. Singapore's government also warned that high oil prices could stunt growth next year.

China's importance as an export market for other Asian economies makes the country's growing dependence on foreign oil a particular concern. Most Southeast

Asian countries, moreover, do not use energy efficiently. So the higher energy bills are lifting costs, another drag on production.

Manufacturers can't pass along the higher costs to their foreign customers. Andy Xie, a Morgan Stanley economist, says companies lack

the proprietary technology or brand identity that can give them leverage over buyers to preserve profit margins.

Businesses appear to be raising domestic prices to make up for exports' narrowing profit margins. Inflation has accelerated across the region. In the Philippines, consumer prices were up 6.3% in August from the previous year, vs. 3.1% at the end of 2003. The Central Bank of the Philippines may soon have to follow Thailand and hike interest rates.

Higher inflation and borrowing rates could erode consumer purchasing power, especially if the excess supply of unskilled labor keeps wages down. There has been a move in the region to lift domestic demand as a means of reducing the reliance on exports for growth, but the latest oil-related developments could deal a blow to these efforts. ■

—By James Mehring in New York

INFLATION IS BUBBLING UP

CONSUMER PRICE INDEXES
DEC. 2003 AUG. 2004

	DEC. 2003	AUG. 2004
Indonesia	5.2%	6.7%
Malaysia	1.2	1.3*
Philippines	3.1	6.3
Singapore	0.7	1.6*
Taiwan	-0.5	2.5
Thailand	1.8	3.1

* yearly percent change from a year ago
Data: Bloomberg Financial Markets

News Analysis & Commentary



BATTLE IS JOINED

Intel's Barrett is scrambling to slow the advance of AMD's Ruiz

CHIPMAKERS

SUDDENLY, IT'S AMD INSIDE

The perennial underdog is challenging Intel with a new class of microprocessors

FOR 35 YEARS, ADVANCED Micro Devices Inc. stood in the shadow of archrival Intel Corp. AMD churned out lower-priced clones of the tech leader's chips and occasionally enjoyed a hit that helped boost its meager profits. But bad times easily outweighed the good. Again and again, Intel used its manufacturing muscle and pricing power to stymie AMD's ambitions, preventing it from gaining a foothold in lucrative markets such as servers and corporate PCs.

Wave goodbye to the great imitator. In what may prove to be an historic reversal of fortune, AMD Chief Executive Hector de Jesus Ruiz has grabbed the momentum from his giant rival in recent months and left Intel scrambling to catch up. The perennial underdog was first to market by

more than a year with a new class of microprocessors that's proving extremely popular with corporate clients. It has smoothly launched new manufacturing techniques, while Intel has been plagued with an uncharacteristic string of delays, glitches, and recalls. And it pushed forward so aggressively with a new "multiple core" chip design, which squeezes several processors on one chip, that Intel was forced to speed up its own transition on some chips by as much as two years. In a humbling moment, Intel executives announced the acceleration at the Intel Developer Forum on Sept. 7, a week after AMD showed off a working version of its own multiple core processors. "We've had some fumbles," says Intel President Paul S. Otellini.

AMD is making the most of its newfound edge. The Sunnyvale (Calif.) com-

pany has grabbed 7% of the low-end server market, up from almost nothing two years ago. It passed 50% of the U.S. retail store sales for desktop PCs in recent weeks. And the company is using new manufacturing techniques in the memory-chip market to outgun rivals both on cost and technology, analysts say. When Intel shocked Wall Street on Sept. 3 by slashing its forecast for third-quarter sales and profit margins, the chip giant cited "lower than expected worldwide demand." But AMD says it's seeing no indication of a broad slowdown, and analysts say that Intel's troubles have been exacerbated by its pesky rival. "It's clear they don't have the products that customers want today," says Ruiz. "That's just the way it is."

With the ball firmly in his hands, the 58-year-old Mexican immigrant plans to

make this a new game. He ticks off a list of ambitious goals for the company: 10% of the low-end server market by yearend, 30% of the corporate PC market in five years, 50% of the consumer PC market in five years. And in flash memory chips, which store data in digital cameras and other devices, he's aiming to make AMD the leading provider, topping Intel, Samsung Semiconductor Inc., and a slew of others in the fiercely competitive field. "We're here to stay," he says. "We're not going away."

So confident is Ruiz, who holds a PhD in electronics, that he's targeting growth markets well beyond AMD's traditional strengths. Last year he created a group to figure out how to incorporate AMD processors into non-PC devices such as cellular phones and consumer electronics. And *BusinessWeek* has learned that AMD is planning to announce as early as October that it is teaming up with contract manufacturers to create an inexpensive, networked PC for sale in India or China. It's part of Ruiz's ambitious plan to help connect 50% of the world's population to the Internet by 2015.

SEA CHANGE

THE COMPANY'S STRIKING success raises the possibility of a profound shift in the technology industry. Intel has long dominated the microprocessor business, in much the way that Microsoft Corp. has dominated software for PCs. But if Ruiz can reach his goals, what was once a near-monopoly could become a more competitive duopoly. That could spark faster development and more innovation. And since microprocessors are the brains of all things digital, the benefits could spread to everything from computers to flat-panel televisions. "It will be good for the industry and good for the consumer," says Jay Desai, founder and CEO of the Institute of Global Competitiveness, a think tank and consulting firm in Cary, N.C.

Can Ruiz keep going toe to toe with Intel? It would be a small miracle. Intel has so much more heft, money, engineering talent, and other resources that, with a determined effort, it should be able to turn back AMD in short order. Intel is almost seven times as large, with expected revenues of \$34 billion this year. Its projected 2004 profits of \$7.35 billion mean that Intel

earns in 11 days what AMD will make all year. And Intel is sitting on \$14 billion in cash, compared with \$1.1 billion for AMD, giving Intel a vast edge in funding research and development and in constructing cutting-edge manufacturing facilities.

Still, at least for now, AMD is defying the odds. The company looks as if it will easily hit Ruiz's server target and has a good shot at grabbing 50% in consumer desktop PCs. Although AMD will probably fall short of its 30% goal in the corporate PC market—a bastion for Intel and its closest ally, Dell Inc.—its multipronged attack is nevertheless sharply boosting sales. Moreover, it will most likely put the company in the black this year for the first time since 2000. For 2004, revenues are expected to surge more than 50%, to \$5.3 billion, while net income hits \$227 million, according to consensus estimates. In 2005, revenues are projected to climb a further 10%, to \$5.8 billion, as profits hit \$328 million.

For the first time in the company's history, AMD wields a potent weapon that makes Ruiz's ambitious goals more than a wish list. Last year the company took the wraps off the world's first industry-standard chip that can process data in chunks of either 64 bits or 32 bits at a time, without any performance trade-offs. The chips, dubbed Opteron for servers and AMD Athlon64 for high-end PCs, offer the cheapest possible path to the next level of high-performance computing.

Its success is due in no small part to Intel's missteps. Intel announced it was working on a rival 64-bit chip, Itanium, back in 1994, about five years before AMD announced plans for its own version. Itanium, however, didn't hit the market until 2001, two years late, and even then was a huge flop. Intel released a second version of Itanium in 2002, but it was never the hit Intel expected because it required companies to rewrite their exist-

CLEAN ROOM

AMD's Dresden plant makes the 64-bit chip



ing 32-bit software to take advantage of the new architecture.

That gave AMD an opening. In March of 2003, the company released Opteron. Although it too was delayed, corporation quickly warmed to it because it could handle both the older 32-bit software and new 64-bit applications. That saved companies headaches and millions of dollars in transition costs. "It's no small fact that although a small company, AMD is going to drive the architecture for the next generation of microprocessors," says Banc of America Securities analyst John Lau.

Intel is scrambling to stop that from happening. In July, CEO Craig R. Barrett sent a blistering e-mail to employees saying that the recent execution trouble were "not acceptable." Barrett and Otellini, who is expected to take over as CEO in

AMD Comes On Strong

Intel once wielded near-monopoly power in the microprocessor market, but now AMD has transformed

itself into a legitimate competitor in several key sectors. CEO Hector Ruiz vows that this is just the beginning.



SERVERS

MARKET Intel made a costly mistake when it introduced 64-bit chips that required corporations' old software to be rewritten. AMD came out with a more cost-effective, friendly product that runs both new 64-bit and old 32-bit programs on the same chip. That has allowed AMD to grab 7% of the low-end server market in virtually nothing less than two years ago.

OUTLOOK Ruiz is likely to grab 50% of the servers by yearend. Hewlett-Packard, Sun, and IBM all are selling AMD-powered products.



2005, instituted a companywide review of upcoming chips. The result: Intel jettisoned several chips under development, quickly introduced a server chip that could handle 64-bit and 32-bit software, and shifted nearly all of its engineers to work on multiple-core chips for servers, desktops, and notebook PCs. To help jazz up its brand and broaden its marketing message beyond the core PC market, the chipmaker also announced on Sept. 7 it had lured Eric B. Kim, Samsung Electronics Co.'s top marketing exec, to work in the same capacity at Intel. Otellini says the company is "going back to the basics."

LONE HOLDOUT

ONE OF THE KEY PLAYERS in the battle between AMD and Intel will be Dell. The Round Rock (Tex.) company is the lone

holdout against AMD among the major computer makers. Dell uses Intel chips exclusively in both servers and personal computers, even though IBM, Sun, and Hewlett-Packard have started using AMD's chips. One reason for Dell's loyalty is that it derives loads of benefits from the close relationship, including millions in marketing dollars from Intel and early insights into future technologies. Ruiz figures that the only way to persuade Dell to use AMD chips is to win over so many customers that Dell is forced to change. Already, Dell rivals are crowing about the brisk business they're doing with Opteron servers. "Our Opteron boxes are just flying off the shelf," says Sun Microsystems Inc. Chief Executive Scott G. McNealy. A Dell spokesman says it is constantly evaluating suppliers but

won't comment specifically about AMD.

Dell's reticence is one reason for AMD's mixed prospects in the PC market. The chipmaker is making progress in consumer PCs, particularly desktop models, because of its low prices. But the more lucrative corporate market is proving much more difficult to penetrate. There, AMD holds only about 8% share and, without winning over Dell and getting more support from IBM and others, that's unlikely to increase very much.

AMD has also been stymied by product delays at Microsoft Corp. The software giant originally planned to release a 64-bit operating system this year, but that has been pushed back until the first half of 2005 because Microsoft needed more time to improve security in Windows. The AMD Athlon64 desktop chip, which launched last year, is expected to shine when paired with the software for which it was designed. Microsoft's delay has given Intel time to fine-tune a competing chip to go with the software giant's release. Otellini says the chipmaker will have a 64-bit desktop chip when Microsoft rolls out the Windows update.

Perhaps the most difficult task for AMD is building credibility with investors. The chipmaker has a long history of inconsistency. Impressive products often have been followed by flops. Investors remain skittish, despite the strong financial performance of late. The chipmaker's stock trades at about \$11 a share, not far above its 52-week low.

Still, for Ruiz, the company's improving fortunes and recent success against its nemesis are accomplishments worth celebrating. At a gathering with employees in July, he grabbed his Gibson guitar, introduced Peter Frampton, and launched into an impromptu jam session. "We should have some fun while working so hard," he says. It has been a long time since an AMD exec could utter such a simple phrase. ■

—By Cliff Edwards in Sunnyvale, Calif.

BUSINESS PCs & NOTEBOOKS

MARKET Intel continues to be the dominant force. AMD's 8% share has remained largely unchanged in recent years.

OUTLOOK Ruiz hopes to use the company's success in the server business to convince corporations to buy more PCs and notebooks featuring AMD semiconductors. He wants 50% of the market by 2008, but that's a long way off. For now, HP is the only major PC maker offering multiple products powered by AMD to corporate buyers.

CONSUMER PCs & NOTEBOOKS

MARKET AMD has done well catering to the cost-conscious consumer, hitting 50% of U.S. retail store sales for desktop PCs. Intel is still the clear leader in notebooks because of the popularity of its Centrino chips for wireless computing.

OUTLOOK AMD is pushing to grab 50% of the consumer market by 2008. But meeting that ambitious goal looks unlikely. Intel's strength in notebooks and entertainment PCs should help it keep the upstart at bay.

NEW MARKETS

MARKET Both Intel and AMD are trying to move beyond the slow-growing PC market. They've targeted wireless communications, digital entertainment, and emerging markets.

OUTLOOK AMD is likely to cut into Intel's expansion possibilities. It's developing chips for a range of digital devices, including TVs, set-top boxes, and cell phones. In October it will release the first set of AMD-powered, low-cost networked PCs for emerging markets. But making money will be a big challenge for both companies.

INCOME TAX

WHAT A 'FAIRER' TAX CODE MIGHT LOOK LIKE

A reelected Bush may rework the existing system—or try for a consumption tax

PRESIDENT GEORGE W. BUSH has the tax code back in his sights—but this time he's not just talking about tax cuts. In his Sept. 2 speech to the Republican National Convention and on the stump since, he has called for making the tax system "fairer, simpler, and more pro-growth" than the current "complicated mess." Few Americans would argue with that goal, but the President is playing it safe: He's postponing the details until next year, when he would name a bipartisan commission to design a plan. Despite that fogginess, Bush's three previous

tax cuts and other ideas he has floated offer some hints as to where Bush-style reform might go. Here's a look ahead:

Why did Bush bring this up?

No politician ever lost votes by attacking the Internal Revenue Code. As Ronald Reagan showed in 1984, calls for fairer, simpler taxes are popular—and sometimes lead to major changes, such as the landmark Tax Reform Act of 1986.

But Bush has more than campaign rhetoric on his mind. He and his advisers believe that reducing taxes on savings and investment income helps spur economic growth. In his first term he reduced the effective tax rate on capital income by nearly one-fourth by slashing rates on dividends and capital gains and by expanding business tax breaks for purchasing capital equipment.

Now some of his advisers see tax reform as the next step toward driving taxes on investment even lower. "A zero tax on capital is the right way to go," says R. Glenn Hubbard, former top economic ad-

viser to Bush and godfather to his first-term cut in taxes on dividends.

So will this simply lead to another round of tax-cutting and rising deficits, without revenue increases elsewhere to make up the shortfall?

Not likely. Bush has vowed to halve the deficit by the end of his second term. With even Republicans beginning to feel queasy about the soaring deficit, he'd have a hard time walking away from that pledge. The

Administration might claim that tax cuts will juice up growth enough to pay for themselves. But the record doesn't offer much support.

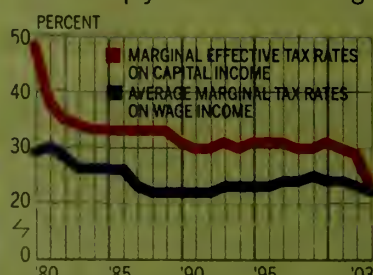
More likely, Bush aides say, any tax overhaul would be designed to be revenue-neutral. But to get there, Bush would have to close loopholes to pay for any rate cuts or fresh exemptions. "One piece

of this has to be raising someone's taxes," says Congressional Budget Office director Douglas Holtz-Eakin. "And that's politically difficult."

Until now, neither the current Con-

HOW LOW?

Taxes on capital have dropped far more sharply than those on wages



Data: Jane G. Gravelle, Congressional Research Service, National Bureau of Economic Research

gress nor the Administration has shown any inclination to make such hard choices. If they could muster the political will such an approach could actually help the White House meet some expensive goals—like corralling the runaway alternative minimum tax. That levy forces individuals to figure their taxes twice, the pay the higher tab. Intended to snag the very rich, the AMT is now hitting middle-class families because it isn't indexed for inflation: The number of AMT taxpayers is projected to soar, from 3 million in 2004 to 23.5 million in 2008. Repairing the AMT will cost upward of \$600 billion. That tab might be easier to bear as part of a sweeping tax overhaul.



FRENZIED FILING
Critics say Bush is trying to exempt all capital income

stuff that reform is supposed to clean out. So Bush is likely to favor a version of the income tax that lightens the burden on savings and taxes consumption instead.

How would a shift toward taxing consumption differ from what we have now?

The existing code is a complicated hybrid. We call it an income tax, but it doesn't actually tax all income: The value of fringe benefits, such as health insurance and parking, goes untaxed. And the treatment of investment income verges on haphazard. About half of all capital income goes to tax-exempt accounts such as 401(k)s or pension funds. And companies often shelter their earnings from corporate taxes.

On the other hand, many companies do pay tax on their profits, then investors pay tax again on dividends or capital gains. So returns on investment may be taxed twice, once, or not at all.

A consumption tax, by contrast, is simply a levy on spending. In other words, you would take all the money you earn, subtract what you save, and pay tax on the rest.

How would Washington collect such a tax?

It could add a sales tax to the final price of goods and services we buy at the retail level, just as most states do today. Or it could have businesses pay the tax at each stage of production and pass the cost on to consumers in the form of higher prices. This is the value-added tax, or VAT, that

most European countries use. Finally, the feds could collect the money through a system of tax withholding and annual returns, much as they do today. That version is called a "consumed income tax."

How would a consumed income tax work?

Think of an unlimited individual retirement account. You would simply list your income—including, possibly, all your fringe benefits and other goodies that are currently excluded—then subtract everything you save and invest and calculate tax on what is left. Investment earnings would be taxed once they are cashed in and you have used them to buy something.

Isn't that like the retirement savings accounts Bush has already proposed?

Bush has proposed two new savings vehicles: retirement savings accounts (RSAs) and lifetime savings accounts (LSAs). Together they would let a couple sock \$20,000 a year into savings and never pay tax on the earnings—eliminating all taxes on capital for 95% of individual taxpayers, according to William G. Gale of the Urban-Brookings Tax Policy Center.

Are those a step to a consumed income tax?

Not at all. RSAs, LSAs, and cuts in capital gains and dividend taxes are not tax reform. They are merely cuts in taxes on investment. Under a true consumption levy, allowing investment income to go tax-free would have to be coupled with ending the tax deduction for interest paid by corporations and by homeowners on their mortgages—a huge and far less popular change.

Why would interest deductions need to go?

Because if you can deduct interest on a loan, invest the money, and earn tax-free profits, you essentially get a government subsidy for investing. That would open up a new world of tax shelters and destroy the benefits of reform. Worse, it would create a system where only wages are taxed. That would be unfair to working people. And a wage tax could never produce enough revenue to fund the \$2.4 trillion the government spends each year.

If Bush pushes for bigger savings exemptions, he might try to pay for them by eliminating the interest deductions currently available to corporations. But don't look for him or any other politician to propose eliminating the deduction on home mortgage interest any time soon. It remains politically untouchable.

What do the Democrats have to say about all this?

Not surprisingly, they're skeptical. Presidential nominee John Kerry argues that Bush's real agenda is to exempt all capital income from tax. When Bush said at an August campaign stop that a national sales tax was an "interesting idea," Kerry pounced. He will also argue that Bush, whose tax cuts have made the code far more complicated, can hardly claim to favor simplification.

The sales tax debate is being tested in the South Carolina Senate race, where Republican Jim DeMint backs a 23% national sales tax. His Democratic opponent, Inez Tenenbaum, is blasting

So what would tax reform look like?

It depends how ambitious Bush is. He could settle for closing some loopholes to buy down rates further without changing the underlying structure of the income tax. Or he could push harder for savings exemptions and take the code toward a system based on taxing consumption.

The first approach would echo Reagan's 1986 triumph, dumping scores of special-interest tax breaks and using the money to sharply reduce rates. But Bush has been moving in the opposite direction. In his campaign, he is promising new tax breaks to encourage spending on everything from health care to fuel-efficient cars—just the kind of

him for favoring price increases on everything from prescription drugs to baby formula.

Don't many experts argue that a consumption tax is the way to go?

Only if done right. That would require eliminating interest deductions and other tax breaks—a tall order for politicians. But if Washington did adopt a well-designed consumption tax, would be simpler than the current code, it would eliminate the double taxation of capital income, and sharply reduce the use of shelters. And most economists believe it would boost growth at least by a few tenths of a percent each year. Economist Alan J. Auerbach of the University of California at Berkeley figures it would push up gross domestic product by 9% over several decades. But a consumption tax's biggest virtue, say supporters, is that it is fair. "You work and save. I work and don't. Why should you pay more tax than me over your lifetime?" asks Urban Institute senior fellow C. Eugene Steuerle, who helped draft the 1986 tax reform.

But doesn't it let the wealthy off the hook?

Even its biggest supporters concede that a consumption tax can be regressive. Because rich people spend a much smaller chunk of their income than do poor people, the wealthy would end up paying a far lower share of their resources in taxes.

Consumption taxes can have progressive rates that mimic today's system. But even that breaks down for the very rich, who would never spend enough to pay much tax. A tough estate tax might smooth things out. So could combining a VAT with an income tax that might kick in for taxpayers earning, say, \$100,000 or more—an idea proposed by Yale law professor Michael J. Graetz, a top Treasury Dept. aide in the Administration of former President George H.W. Bush. But for now that's an idea far beyond anything the Administration is considering.

How likely is Bush to achieve tax reform?

Depends on his priorities. If reelected, Bush will confront tax reform, overhauling Social Security, making his tax cuts permanent, and fixing the mangled Medicare bill that was passed in 2003. He won't be able to do it all. But don't be surprised if shuffling the tax deck isn't part of a second-term agenda. ■

—By Howard Gleckman and Mike
McNamee in Washington

COMMENTARY

BY JEFF GORDON

AND MICHAEL J. GORDON



One Game Plan Is Enough for Kerry

The candidate needs to focus—and junk bad advice

THE EUPHORIA THAT Democrats felt after John Kerry's Boston convention has faded, obliterated by a furious

August offensive from the GOP. After spending the month leading up to the Republicans' New York conclave on the defensive over Vietnam

and Iraq, the Democrat watched George W. Bush deliver a strong Sept. 2 address that moved the numbers. Thanks to his mini-bounce, the President now holds a 7-point lead among likely voters in the new CNN/USA Today/Gallup Poll. But while history shows that many post-convention spurts are ephemeral, Kerry has reacted by hitting the panic button—a step that seems unwarranted with seven weeks to go in

a race against a polarizing incumbent.

In a series of actions reminiscent of Al Gore's 2000 campaign, Kerry is frantically adding to a top-heavy staff, launching roundhouse attacks on his foe, and trying to shift the focus from his alleged character flaws to "it's the economy, stupid." Meantime, he's being bombarded with advice from Dems—who want a sharper message but have doubts about the messenger.

Kerry's bind is real. But it's by no means fatal. Like all campaigns, this one is really a series of large engagements

with the most important yet to be fought. The first big battle was the summer air war, an ad blitz in battle ground states. Aided by independent "527" committees, Kerry fought Bush to draw on spending and established himself as a credible candidate. But Bush, pounding away at Kerry's

**Best debate
points: Iraq
and better
health
coverage**



THIS IS NOT SPEND MANAGEMENT.

ARE YOU HUNTING FOR DATA INSTEAD OF IDENTIFYING OPPORTUNITIES?

The hunt is on. Once again, you're looking for clues as to how, why and where your dollars are flowing. Can you spot your next sourcing opportunity in the accounting reports? If not, you've spotted the need for Spend Management. And also Ariba. We can pull together data from disparate (and often incompatible) sources, help identify savings and transform your business. To learn about Ariba Analysis Solutions, please call 1-866-772-7422. Or visit www.ariba.com/analyze for your free Spend Management Opportunity Assessment.

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SOURCING

PROCUREMENT

SUPPLIERS

alleged fondness for flip-flopping, sowed doubts about his challenger's character. Slight edge, Bush.

The President won a clear victory in the second encounter—the month-long duel of the political conventions. While Kerry used his pageant to focus almost exclusively on service in the Vietnam War, Bush scored a trifecta. He reestablished his compassionate conservative bona fides, reached back to his reformist roots for a second-term agenda, and bolstered his image as a strong leader in the global war on terror. Big advantage, Bush.

The next key face-off—and the decisive one—will come as soon as Sept. 30 when the first Bush-Kerry debate is set to air in Miami. Given the unpopularity of the Iraq war and Bush's 51% disapproval rating on the economy, Kerry has an opportunity to regain lost ground if he can make a coherent case for a return to a more traditional foreign policy and expanded health insurance coverage.

The conventional wisdom is that Bush, with his sly, folksy style, will show Kerry to be an insincere, double-talking Washington insider. But if Kerry ever gets focused, he could win the duel on points. Then he could roll into October with a head of steam—and count on the Democrats' ground organization to push him to a victory on Nov. 2.

Critical Debates

TODAY, THAT LOOKS like a long shot, thanks to a Bush search-and-destroy strategy that is making Kerry less acceptable to key voting blocs. According to Gallup, Bush has erased a 9-point pre-convention Kerry lead among independents, and now scores 44% to 43%, with 8% leaning toward Ralph Nader. Over-65 voters, who backed Kerry by four percentage points, now prefer Bush by 49% to 47%, with Nader at 1%. What about the \$30,000-\$50,000 a year wage-earners that Kerry has targeted? Before New York, they favored him by 3 percentage points. Now they go for Bush, 52% to 41%.

Bush's spurt in the polls is also threatening an electoral-state edge that Kerry held all summer. Pollster John Zogby finds that the President gained ground in Ohio, Pennsylvania, West Virginia, Wisconsin, and Arizona. It's hard to see how Kerry can prevail without Ohio and Pennsylvania unless he somehow wrests Florida from Bush. Kerry has lost his July lead in the hurricane-battered Sunshine State, and the race there is now dead even.

Small wonder, then, that Kerry's inbox is piling up with helpful hints. But he

ought to proceed cautiously, since many ideas forged in the grip of panic have a way of backfiring. Among them:

THE GIVE 'EM ZELL STRATEGY. Reacting to a Kerry-slamming convention speech by renegade Democrat Zell Miller of Georgia, many Dems want their champion to unleash a searing counterattack on everything from Bush's service in the Air National Guard to his Administration's fumbled occupation of Iraq. While this would make liberals feel better, many Americans revere the Presidency and won't take kindly to a slashing exchange. If

Kerry veers into Bob Dole-style "stop lying about my record" bitterness, he will end up a net loser. The right course is to offer concrete ideas for fixing the Iraq mess—big picture stuff, not minor nits over occupation mechanics—while avoiding personal attacks. Kerry needs to explain clearly, for instance, whether he thinks we now have enough troops on the ground or too few, and how he foresees getting to the point where they can be considerably reduced.

SHUFFLING STAFF. Reacting to advice from former President Bill Clinton, Kerry has signed up platoons of Clintonites for a new rapid-response unit. But the newcomers might not work in harmony with Kerry's current crew, led by strategist Bob Shrum and campaign manager Mary Beth Cahill. The new recruits are feisty but are mistaken if they think that grafting Clinton's '92 campaign strategy onto Kerry's bid will succeed. Even on his best day, Kerry can't match Big Bill's charisma. Rather than vacillating between the stay-the-course camp and the Clinton Reduxers, he should pick one course and follow it instead of meandering. On the road, Bush practices relentless message discipline. Kerry, by contrast, is constantly straying off-message and free-associating. Democratic strategists say he needs to find a way to take the fight to Bush in a few clear and incisive phrases. And when he takes a position, he must stick with it.

BACK TO THE ECONOMY. Sensing that Bush has turned the campaign into a debate on terrorism, Democrats want Kerry to talk more about jobs, jobs, jobs. But jobs are coming back, even in some of the Rust Belt states that Kerry is targeting. The Democrat's best issue is the complex set of social pressures known as the middle-class squeeze, but that can't be his only issue. National security is too big to be ignored. Voters want to know how he would extricate the U.S. from the Iraq mess and step up the war on al Qaeda.

Clearly, Kerry has dug himself into a huge hole, and Bush is pounding him deeper with sledgehammer blows over character. That has upped the stakes in the debates, which are likely to be far more important with late-deciders than the earlier skirmishes of Campaign '04. A solid debater, Kerry still has time to shake off his swoon and emerge as the Comeback Lieutenant. But time for late heroics is growing short. ■



Bush's Bounce

How the GOP convention moved voters in several key blocs:

PRE-CONVENTION			
	BUSH	KERRY	NADER
Independents	37%	46%	8%
Elderly voters	45	49	1
College grads	41	53	2
\$30,000-\$49,000 income	45	48	3
Under \$30,000 income	33	56	5
POST-CONVENTION			
Independents	44%	43%	8%
Elderly voters	49	47	1
College grads	58	38	3
\$30,000-\$49,000 income	52	41	6
Under \$30,000 income	43	49	5

Based on a pre-convention survey of 1,876 registered voters conducted Aug. 28-29, and a post-convention survey of 1,926 registered voters conducted Sept. 3-4. Margin of error of ±4 percentage points.
Data: CNN/USA Today/Gallup Poll



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THE ECONOMY

WHY GREENSPAN IS STAYING THE COURSE

Despite a recent dip in inflation, the Fed chief has good reasons for more rate hikes

WHEN FEDERAL Reserve Chairman Alan Greenspan kicked off his credit-tightening campaign on June 30, there was no question why he was raising interest rates. Inflation was picking up, and the recovery appeared to be on solid ground: Gross domestic product had grown at a 5.3% annual rate over the previous three quarters, and even the sluggish jobs market had finally sprung to life.

Now, though, the case for tightening isn't as obvious. Despite a 40% leap in oil prices since late last year, inflation has ebbed. Meanwhile, the jobs market has softened. While the 144,000 rise in August payrolls was double the dismal 73,000 increase in July, it was well below the heady 295,000 monthly pace of the spring. That has led some at the Fed to wonder whether they should pause before moving ahead with further hikes.

But despite the uneasiness of some of his colleagues, Greenspan left little doubt in congressional testimony on Sept. 8 that he's intent on raising rates when the Fed meets two weeks later. While taking

comfort in the recent dip in inflation, Greenspan believes price pressures will pick up eventually if the Fed keeps rates low for too long. Something that bears watching: Labor costs—considered by Greenspan to be a key factor behind inflation—have turned up.

CONFLICTING REPORTS

AT THE SAME TIME, the Fed chief is convinced that the recent slowdown will be short-lived and that the economy is strong enough to take another quarter-point hike. Indeed, Greenspan told Congress that "the expansion has regained some traction." He cited a July pickup in consumer spending and housing starts and continued solid business investment.

What's more, Greenspan seems unsure whether job growth has been as subdued as the latest payroll numbers suggest. A separate government survey of employers used to measure job openings

THE LONG VIEW
Productivity is slowing as health costs rise

did not show the same degree of weakness as payroll numbers did. According to that survey, private-sector job

openings jumped markedly in July.

While Greenspan welcomed the recent decline in inflation, it did not come as a surprise. Throughout the spring, as criticism of the Fed's lax monetary policy mounted, he argued that the rise in inflation was likely to prove "transient." And so it has. After climbing sharply last year, commodity prices have leveled off in recent months as supply has started to catch up with global demand. Even oil prices have come off their peaks, though Greenspan conceded on Sept. 8 that the outlook is uncertain. More important, there's little sign that higher oil prices are seeping into the rest of the economy. Excluding energy, consumer prices rose just 2.1% in the year through July.

What Greenspan is focused on is the long-run outlook. And on that score there's reason for caution. Productivity growth is slowing from its recent super-strong levels. Coupled with rising wages and health-care costs, that's pushing up Corporate America's outlays for labor. After falling steadily over the past two years, unit labor costs at nonfinancial companies have grown in 2004, rising at an annual 2.6% pace in the second quarter.

The Fed is hypersensitive to even small signs of wage inflation because interest rates are so low. Despite two Fed rate hikes this year, the federal funds rate—the rate commercial banks charge each other for overnight money—stands at a mere 1.5%. That's far below the 4% or so that some Fed officials reckon is the equilibrium rate for the economy. And as long as rates are below that level, Fed officials believe monetary policy is acting to stimulate growth and push up inflation.

Through one of the most perplexing recoveries in memory, Greenspan has steered a consistent course. He ignored the pleas of inflation hawks for bigger rate

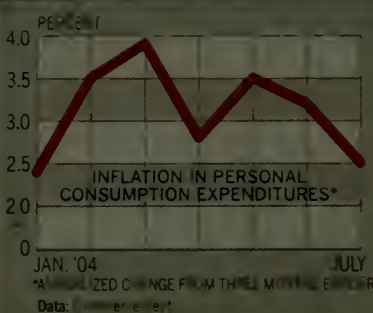
hikes when prices spiked in the spring and now he's playing down worries of the doves as growth slows. He figures a slow-but-steady flow of rate hikes will avoid surprising the markets—and be best for the economy in the end.

—By Rich Miller in

Washington, with

Peter Coy in New York

PAST ITS PEAK?





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A NEW FRONTIER FOR SUBURBAN BUILDERS

Land scarcity has tract developers tackling blighted urban properties



BIG PAYOFF
Pulte's
condos in
Emeryville

BOSTON'S FAN PIER IS just the kind of choice waterfront property that urban developers have used to help reinvigorate cities stretching from New York to San Francisco. But when a 21-acre parcel located across the harbor from Logan International Airport was put up for sale in mid-August by Chicago's Pritzker family, the high bidder was a newcomer to big cities. The \$125 million winning offer came from a group led by Miami's Lennar Corp., a company best known for sowing suburban sprawl across central Florida.

Lennar isn't the only suburban builder heading downtown these days. Among the newest players now moving into urban housing are such tract homebuilders as Toll Brothers Inc., based outside of Philadelphia, and Los Angeles' KB Home. Both have spent decades trying to lure folks out of the city. Now, faced with a land scarcity in the 'burbs that threatens to crimp their growth, those same companies are suddenly making a reverse commute of their own by gobbling up ur-

ban properties at a fevered pace. "As land becomes rarer, you have to look for new areas where you can drive growth," says KB Home CEO Bruce E. Karatz, who vows that urban projects "will be a bigger part of our business."

To be sure, the downtown market is fraught with challenges for the suburban builders—including strict zoning requirements and environmental cleanups of some industrial properties, as well as land and construction costs that are far higher than what they're used to in the suburbs. What's more, builders accustomed to having carte blanche in the exurbs often find themselves in protracted negotiations with zoning officials and preservationists who demand that each project be tailored to the community. "It's higher-profile, so many people have opinions," says Karatz.

For suburban builders

who get it right, however, the urban market can yield profits every bit as fat as what they make in suburbia. Consider Pulte Homes Inc.'s foray into Emeryville, Calif. Just across the bay from San Francisco, the city was an industrial wasteland full of abandoned factories and toxic cleanup sites. Pulte ponied up a hefty \$55 per square foot for a property that had been an oil tank farm—which included \$800,000 in environmental remediation costs. Now the development's one- and two-bedroom condos have been selling briskly at \$509,000 to \$649,000, or roughly \$475 per square foot. The payoff? A return on capital of greater than 20%—comparable to Pulte's suburban developments—and the gratitude of city officials for converting an abandoned property into housing. "They've been an asset to the community," says City Councilmember Nora Davis.

DESIGN CUES

FOR NOW, URBAN development remains a small part of the portfolio for most of the big homebuilders. But it's growing quickly: While the government doesn't keep data on urban-vs.-suburban construction, the U.S. Census Bureau estimates that sales of newly built townhomes—which tend to be located in urban areas—now represent 13% of all new homes sold, vs. 10% in 1999. And KB's Karatz says that urban housing will constitute 6% of the 32,000 homes his company builds this year, up from virtually nothing four years ago.

Of course, there's always a chance that the builders, unfamiliar with the tastes of urban homebuyers, may trip up. When Texas suburban builder Perry Homes moved into the Heights, an old neighborhood near downtown Houston, sales of its brick townhouses initially were slow. Only after the developer shifted to a design that took cues from the Victorian style of the neighborhood did sales pick up, says Mel Reyna, broker at Greenwood King Properties.

The shift downtown won't mean the end of suburban sprawl. But with their billion-dollar balance sheets and extensive expertise, the big builder promise to give a boost to the nation's resurgent urban neighborhoods. ■

—By Christopher Palmeri in Los Angeles

THE STAT

6%

Share of KB Home's portfolio devoted to urban housing this year, up from nothing four years ago

Source: KB Home



RETAIL

SHARPER IMAGE NEEDS ...A SHARPER IMAGE

Suddenly its air purifier, which made up a huge chunk of sales, isn't such a hot ticket

FOR SIX YEARS, THE IONIC Breeze Quadra air purifier was Sharper Image Corp.'s primo money machine, contributing an estimated 40% to 50% of the gadget retailer's sales. Now, the danger of relying too heavily on one hit product is becoming clear.

As rivals pile into the market, demand is slowing for the \$350 Ionic Breeze, say analysts. That has left Sharper Image scrambling to come up with a hot new gadget to replace it, even as costs are rising and efforts to boost sales by diversifying into wholesale are slashing margins. The result: tumbling earnings and a host of unhappy shareholders. Since early August, when Sharper Image warned that earnings would come in lower than expected, the stock has fallen 29%, to \$18.81. Execs, who declined to comment for this story, have insisted they have the right product mix to get back on track. But analyst Gary Holdsworth of Wedbush Morgan Securities Inc., warns the stores lack a "must-have" gadget. "We'll see a lull until

that happens," he says.

It's quite a reversal for the nation's premier purveyor of high-end gizmos. Founded in San Francisco 27 years ago, the company established itself in the '80s with fogless mirrors and waterproof shower radios. In the late '90s it cashed in on the Razor scooter fad. When that faded, Sharper Image was ready with the Ionic Breeze—which helped double annual sales to \$647.5 million between 1999 and 2003. But with troubles mounting, the company announced on Aug. 19 that same-store sales grew a meager 1% in the second quarter. And despite a 20% sales increase, net income fell 16%, to \$676,000. For the year, W.R. Hambrecht & Co. estimates net income will rise just 4.9%, to \$26.5 million—a far cry from the 58% jump in earnings in 2003.

Sharper Image's biggest problem is that its purifier has run into a buzzsaw of com-

MOMENTUM

After four solid years, sales have stalled

petition. Direct rival Brookstone is selling its new Pure-Ion UV air purifier for \$300; Home Depot and Ra-

dioShack are selling their own versions for \$200. In an effort to goose sales, Sharper Image came up with an easier-to-clean model. But it costs \$400.

CANNIBALIZING?

IT DOESN'T HELP that Consumers Union gave the purifier poor reviews in 2002 and 2003. Sharper Image sued the research group last year, alleging product disparagement. In a July 30 court brief, Consumers Union says its reviews were "truthful and accurate" and that "Sharper Image presents no evidence to show that Consumers Union's conclusions are false or unfounded."

The troubles with the Ionic Breeze come at a time when Sharper Image is relying more on its lower-margin wholesale business. The retailer began putting its products in department stores and the likes of Bed Bath & Beyond and Circuit City in the mid-1990s. The aim was to get the Sharper Image name in front of more shoppers. Now wholesale sales are growing much faster than the rest of the company; in the second quarter, the wholesale unit accounted for 10.7% of sales, up from 3.8% the prior year. That's led some analysts to question whether Sharper Image is merely cannibalizing itself.

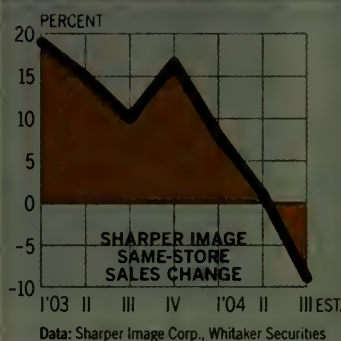
Sharper Image insists it has the products to turn things around. After the August earnings announcement, CEO Richard Thalheimer said sales of the \$800 iJoy Turbo 2 massage chair and a line of Dyson brand vacuum cleaners remain strong. But those products, available elsewhere, aren't nearly as profitable as items such as the Ionic Breeze that

are sold exclusively at Sharper Image.

To top it off, costs are rising. With TV airtime rates way up because of the avalanche of election-related advertising, the company is instead trying to boost catalog circulation by 8% to 10%. Sharper Image is betting that putting more money into the catalogs will be worth it. "The stores look great; the products look great," Thalheimer insisted in August. But if customers don't bite, he could be stuck with more than a few air purifiers after the holidays. ■

—By Louise Lee in San Mateo, Calif.

LOSING ITS EDGE?



EDITED BY MONICA ROMAN

HEADLINER

GERALD GRINSTEIN



MAYDAY, MAYDAY

Time is running out for Gerald Grinstein. The **Delta Air Lines** CEO warned Sept. 8 he would put the money-losing carrier in Chapter 11 if he can't win huge concessions from pilots and creditors by month's end.

A Delta director who took over as CEO on Jan. 1, Grinstein has turned around companies before, including **Western Airlines**. And he is doing a lot to cut Delta's sky-high costs. Grinstein says he will dump up to 7,000 employees, or 10% of Delta's payroll, and reduce pay and benefits for the remainder. Some of those jobs will be in Dallas/Fort Worth, where a hub is being closed. All told, Grinstein says, Delta must cut \$2.7 billion in overhead by 2007. "We have no time to waste," he told workers.

Grinstein has asked Delta's unionized pilots to find \$1 billion in savings. So far they've refused to go along, despite earlier tough talk from the chief. Stuart Klaskin, a Miami-based airline consultant, puts odds of Delta bankruptcy at 50-50.

—Michael Arndt

QUATTRONE'S DAY IN COURT

Back in October, it appeared as if former **Credit Suisse First Boston** investment banker Frank Quattrone had dodged a bullet when a Manhattan jury failed to convict him on charges of obstructing of justice and witness tampering. But federal prosecutors brought their cases a second time, won a conviction, and on Sept. 8 were rewarded with an 18-month prison sentence for Quattrone. The 48-year-old Silicon Valley native faced a maximum of 16 months under federal guidelines. But U.S. District Judge Richard Owen was tougher because he said it was "crystal clear" that Quattrone committed perjury. Quattrone is appealing his conviction.

LUXE IS THE WORD



Even as discounters such as **Wal-Mart Stores** feel the bite of high energy costs and weak job growth, one retail sector shows no signs of slowing: Luxury. Designer emporium **Neiman Marcus Group** reported on Sept. 7 that fiscal fourth-quarter profits more than doubled, to \$21 million, or 42¢ a share, on a 12% boost in revenue. The same day, upscale leather goods retailer **Coach** raised its earnings forecast, buoyed by

robust sales. It now expects fiscal-year earnings of at least \$1.71 a share, up from the \$1.68 it had previously projected. Analysts expect the momentum to continue through the holiday.

KEEPING TABS ON SERVICES

As the services sector has grown, the U.S. government has lagged in compiling timely statistics on how businesses such as architects and telecom outfits are faring. That's about to change. On Sept. 13, the **U.S. Census Bureau** will release a new quarterly survey of revenues of service-producing companies. The survey, the Bureau's first new economic indicator in nearly 40 years, will initially cover the information technology industry, including newspaper and software publishers; professionals like lawyers and ad agencies; and such support services as travel agents and employment agencies. These industries account for some 14.6% of gross domestic product.

MORE FINES FOR FUNDS

In what could be the last big settlement in the mutual-fund trading scandal, **Invesco Funds Group** and **AIM Advisors** agreed to pay regulators \$450 million to resolve charges that they illegally permitted rapid in-and-out trades by favored investors. Under the terms of the tentative deal, Invesco will pay \$325 million and AIM Advisors will pay \$50 million. Both companies, owned by British fund manager **Amvescap**, also agreed to lower their fees by \$75 million over the next five

years. "We deeply regret the harm done to fund investors and have taken strong measures to prevent any recurrence," said Charles Brady, chairman of Amvescap. The pact was negotiated with the attorney general of New York and Colorado and the **Securities & Exchange Commission**.

ET CETERA...

► **GM** raised cash incentives by between \$500 and \$1,000 on most 2005 models.

► **Texas Instruments** reduced its forecast for third-quarter sales to between \$3.1 billion and \$3.24 billion.

► **U.S. Airways Group** failed to reach a deal with pilots, moving closer to bankruptcy.

CLOSING BELL

Avon Products came calling on Sept. 8, and Wall Street didn't like what it heard. Investors knocked 6% off shares, to \$42.86, after Avon said third-quarter U.S. sales would be flat. But it noted stronger foreign revenues would offset the weak stateside results.



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EDITED BY RICHARD S. DUNHAM

Stirring the Passions Of Apathetic Voters

FACED WITH THE MOST POLARIZED electorate in recent American history, both Republicans and Democrats are doing everything they can to turn out loyalists, from pounding on doors to saturating the airwaves with attack ads. But what could get the faithful's dander up—and get them to the polls—is a little more

indirect: initiatives on state ballots that may rally the parties' bases in key battleground states. Heading the list are hot-button proposals to ban gay marriage and increase the minimum wage.

It's true that voters' top concerns are the economy and terrorism, but some of the ballot measures could be the magnets that draw a small but critical group of otherwise apathetic Americans to the polls. "Ballot initiatives have become a very important part of voter mobilization," says Susan A. MacManus, professor of political science at the University of South Florida. "Gay marriage is clearly tied to the strategy [of prodding] religious conservatives to vote. The minimum wage issue is tied to getting out the working poor."

'Turnout Tool'

REPUBLICAN strategists take heart that bans on gay marriage are slated to be offered on ballots in the swing states of Ohio, Oregon, and Michigan this November. Democrats, meanwhile, are pleased that proposals to

raise the minimum wage are on the ballot in hotly contested Florida and Nevada.

While activists pushing a minimum-wage increase to \$6.15 an hour and those peddling prohibitions on gay wedlock aren't officially affiliated with either Presidential campaign, their efforts are geared not just to winning support for their agendas but also to having an impact on the main event. "The people we're contacting have a tendency to be pro-Kerry," says Gail Tuzzolo, a consultant to Nevada's AFL-CIO who is managing the minimum-

wage campaign. "We're hoping to boost turnout among [the target group] by 6% to 8%."

That group is primarily the working poor, particularly women, African Americans, and Latinos. All tend to be underperformers at the polls. In securing signatures to get the initiative on the ballot, activists say they registered 5,500 new voters in Nevada and about 150,000 in Florida. While many of these voters tend to be skeptical of government, they might be persuaded by an appeal to boost their bottom line, says Kristina Wilfore, executive director of the liberal Ballot Initiative Strategy Center. "Telling people that they can vote to give themselves a raise is a powerful turnout tool."



KEY SWING states will offer ballot initiatives to ban gay marriage

29% victory for traditional-marriage forces in Missouri amid an unusually heavy turnout by social conservatives in an Aug. 3 election. "Democrats fear the marriage issue more than any other because it galvanizes people to action," says Robert H. Knight, director of the Culture & Family Institute, an affiliate of the conservative advocacy group Concerned Women for America.

With big issues like war and jobs crowding the agenda this year, gay marriage and the minimum wage might not rank at the top of most citizens' concerns. But in a 50-50 nation, the passions of a few in the right battleground states sometimes can trump the priorities of the many. ■

—By Alexandra Starr

CAPITAL WRAPUP

THE CHAMBER: TAKING ON THE SEC

WHY IS THE U.S. Chamber of Commerce messing with the Securities & Exchange Commission? In mid-August, the trade group, usually focused on bread-and-butter business issues, pushed for an extension of the deadline for comment on an SEC proposal to require hedge-fund managers to register with the agency. And on Sept. 2, the Chamber sued the SEC in a bid to overturn a rule requiring that 75% of a mutual fund's directors, including the chairman, be independent of the fund's investment adviser. The business group is angered by what one Chamber lawyer calls the SEC's penchant for "just-in-case" rulemaking. It contends many of the rules aren't needed and could crimp Corporate America's ability to raise capital. But the lawsuit is a long shot, and SEC insiders say the commission is likely to approve the hedge-fund rule before the Nov. 2 elections.

THE HIGH-STAKES GAME OF STEM CELL POLITICS

BUSH CAMPAIGN officials are furious with top Democrats for repeatedly misstating the President's position on embryonic stem cell research by saying that he opposes it. In reality, he favors restrictions on federal funding but not an outright ban. The issue is sensitive because Americans across party lines back such research by nearly 7-1, according to a Harris Poll released on Sept. 7. Republicans favor it 60%-18% and Dems 80%-5%. Independents are strong supporters at 83%-7%. And despite opposition from Religious Right leaders, born-again Christians back legal research 58%-21%, the poll found.

JUMBO COSTS

Airbus is spending \$13 billion on the A380



AEROSPACE

BOEING VS. AIRBUS: IT'S GETTING UGLY

The two planemakers are raising the volume of their spat over subsidies. Will the dispute go to the WTO?

WHAT'S AIRBUS UP to now? On Sept. 6, Chief Executive Noel Forgeard hinted that the European plane-maker may soon unveil plans for yet another new aircraft even before the double-decker A380 takes its first test flight early next year. Studies on a new plane could start within weeks, Forgeard said, with industrial agreements signed by early 2006.

"Airbus is bubbling over with new projects," he said.

Forgeard's comments followed weeks of rumors that Airbus is set to revamp its A330, a midsize widebody jet, to counter Boeing Co.'s superefficient 7E7 Dreamliner, a brand new 215-seater that's scheduled to get airborne in 2008. Boeing is banking on the 7E7, its first new model since the Boeing 777's launch in 1990, to help regain the lead from Airbus in the global commercial-jet duopoly. A revamped A330 would probably use

lighter-weight composite materials and next-generation engines developed by Rolls-Royce PLC and General Electric Co. for the 7E7. Most analysts reckon such a plane could get onto the market before the 7E7's scheduled debut. And the startup would probably cost no more than \$1 billion, which Airbus could pay out of cash flow even as it wraps up the \$13 billion A380 project.

But will this idea ever fly? A reworked A330 might cost a little less than the 7E7's \$120 million list price, but almost certain-

ly couldn't match the fuel savings and operating efficiencies that are the Boeing plane's key selling points. Airbus could still opt to develop a new aircraft, but it wouldn't be ready for the market until at least three years after the 7E7 makes its debut.

You might think Airbus would want to clear up the confusion—but you'd be wrong. The more Airbus can get airlines wondering what its next move will be, the more the airlines are likely to delay a decision on ordering the 7E7, says Richard Aboulafia, an aerospace consultant with Teal Group in Fairfax, Va. "Their objective isn't to build a plane, it's to undermine the 7E7 business case," he says.

Alas for Boeing, the psychological warfare may be working. No major carrier has announced an order for the 7E7 since last

spring when Japan's All Nippon Airways Co. ordered 50. True, other Boeing models, including the highly profitable 747, were slow to attract customers. Boeing execs say two dozen airlines have shown strong interest in the 7E7, and they're confident of getting 200 orders by yearend. "Airlines are worried about not having the 7E7 because its lower cost structure gives it a 20% competitive advantage," says Mike Grady, a vice-president of Smiths Aerospace, a British avionics supplier.

But many industry watchers were surprised when Boeing failed to land any 7E7 orders at the Farnborough Air Show in Britain in July. Then on Aug. 25, Singapore Airlines Ltd. delayed indefinitely a decision on ordering the 7E7 or the A330. Boeing is counting on Asia for early 7E7 orders, since Asian airlines are gener-

ally stronger than their U.S. counterparts. And Singapore is seen as a trendsetter in the region, says Mark Tan, an analyst with UOB Asset Management Ltd. in Singapore. Now that the airline has decided to wait, other Asian carriers will be reluctant to order the 7E7 soon, he predicts.

As it fights to make the 7E7 a success, there's one way for Boeing to strike back—by turning up the heat on a long-simmering trade dispute over European government aid to Airbus. At the opening of the Farnborough show, Boeing CEO Harry Stonecipher issued a blistering attack on a 1992 bilateral agreement under which Airbus has received billions in European government loans. Boeing argues the deal gives Airbus an unfair advantage and is doubly unjust now that the European planemaker commands more than 50% of the business. "They ought to be able to build [new aircraft] with their own funds. Why don't they go out to the banks to get it?" asks Stonecipher. U.S. trade officials agree and have requested a meeting in Brussels to ask that the pact be scrapped.

While the two rivals have sparred publicly over subsidies for years, Boeing has never pushed the issue to the breaking point for fear of alienating European customers, who included flag carriers of

Boeing fears Airbus will get a leg up in rolling out a rival to its new 7E7

some countries providing loans to Airbus. This latest quarrel, though, looks serious. A European Union briefing paper obtained by *BusinessWeek* shows the EU plans to fire back with complaints that Boeing obtains billions in benefits and tax breaks in the U.S. and in foreign countries where Boeing suppliers receive government aid. If

Airbus loses its government loans, says Ralph Crosby, the North American chairman of Airbus' parent, European Aeronautic Defense & Space Co., "there will have to be an equitable change on the other side."

PSYCHOLOGICAL WARFARE

IN RAISING the subsidy issue, Boeing is playing its own brand of psychological warfare. It's trying to signal the markets that Airbus may lose its government loans, which since 1992 have covered up to one-third of the development cost of new planes, including the A380 and new versions of the widebody A340. The EU says \$5.2 billion in such loans are now outstanding and Airbus has already repaid \$6.5 billion. Boeing's gripe is that the pact lets Airbus avoid repaying the loans in full if sales of the aircraft that is being financed fall short of forecasts. Airbus says that has never occurred. Even so, Boeing contends the deal gives Airbus an advantage by lowering its commercial risk, making it easier to obtain financing.

Airbus is rich now: It posted 9.8% operating margins on \$12.1 billion in sales for the first half of this year. That means it probably could mount a major new aircraft program without government loans—possibly a rival to the 7E7—after the A380's launch in 2006. But Boeing figures that without the governments' implicit risk cushion, Airbus would have a harder time getting customers and suppliers on board—and the 7E7 could steal a march on any rival project.

What's next? The White House wants to renegotiate the 1992 agreement. If negotiations fail, then the U.S. would have to bring a complaint on Boeing's behalf before the World Trade Organization, where resolution of disputes is unpredictable. "We'd prefer negotiations rather than litigation," the U.S. Trade Representative's office says. That still leaves plenty of room for mind games. ■

—By Carol Matlack in Paris and Stanley Holmes in Seattle, with Paul Magnusson in Washington, and bureau reports



Helping Hands

Airbus and Boeing are both getting government aid on their latest planes

AIRBUS A380

\$3.7 billion in loans from European governments, fully repayable only if the plane is commercially successful.
\$1.7 billion in aid and tax incentives from European governments for infrastructure improvements. Indirect aid through European Union aeronautic research programs.

BOEING 7E7

\$3.2 billion in tax breaks from Washington state.
\$200 million in bond repayments forgiven by Kansas. Up to \$2.1 billion in Japanese government loans to local contractors; Italian government aid to state-owned contractor Alenia Aeronautica.

Data: U.S. Trade Representative, *BusinessWeek*

COMMENTARY

BY JOHN ROSSANT

France: Fraying Ties to the Arab World

Its pro-Arab diplomacy isn't helping in the wake of a kidnapping in Iraq

WHEN TWO FRENCH JOURNALISTS were abducted in Iraq by a shadowy Islamist group on Aug. 20, France's initial reaction was consternation. How could this have happened to a country that did so much to oppose U.S.-led war plans in Iraq—and has espoused so many Arab causes? But then France swung impressively into ac-

tion, calling in its Middle Eastern chips. Almost immediately, Palestinian leader Yassir Arafat, Libyan strongman Muammar Qaddafi—and even radical movements such as Hamas, Hezbollah, and Islamic Jihad—were all appealing for the hostages' release. It was a vivid reminder of the time and effort France has put into constructing a web of relations across the Mideast. "You didn't see that kind of support for Blair or Berlusconi," notes François Heisbourg, director of Paris-based think tank Foundation for Strategic Research, referring to the hostage crises faced by both leaders.

But France's political capital in the Middle East may be more rhetorical than real. For all their influence, the French failed to secure the swift release of the journalists. The Gaullist notions of enjoying the support of the "Arab street" are also looking exaggerated: "Many in the Middle East see a double standard, contrasting France's almost lyrical expressions of support for Arab causes with domestic policies viewed as anti-Arab and anti-Islamic, even racist," notes Algerian economist Amr Elmuntasser. French politicians and some of the country's estimated 5 million Muslims have clashed publicly, most recently over new legislation barring female students at French public schools from wearing headscarves. The Iraqi kidnappers made removal of the ban a condition for the release of the hostages.

Just as important, the rush of diplomatic activity cannot hide the fact that around the southern rim of the Mediterranean,

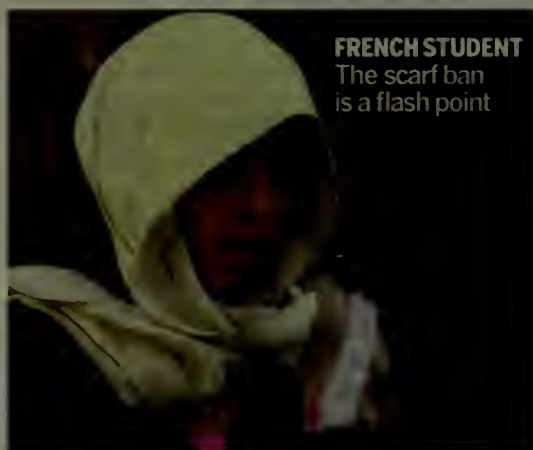
French power and prestige have suffered a number of reversals. Morocco recently signed a groundbreaking Free Trade Agreement with the U.S.—something it has yet to do with the European Union, despite French lobbying. France was also kept in the dark late last year when Libya cut a deal with the U.S. and Britain to mothball its nuclear weapons program.

France still has commercial strengths in the region, which last year purchased \$18 billion in French goods. Around one quarter of the foreign trade of Algeria, Morocco, and Tunisia is still conducted with France. But even here it is beginning to slip. In Algeria, where French companies discovered oil and gas in the late 1950s, Britain's BP PLC is now the leading investor. Similarly, Italians have edged out the French in the energy industries of Egypt and Libya. What's more, France's traditional focus

on exporting to "captive" Middle Eastern and African markets has caused it to miss out on much of the Asian boom.

French commercial ties with Iraq underscore the fact that business does not necessarily translate into political influence. French exports to Iran nearly doubled in the five years to 2000. Carmaker Renault will be plowing \$360 million into a car plant there while energy giant Total is betting big on oil and gas stakes. Yet all this investment hasn't stopped Iran from snubbing French diplomatic appeals to halt its nuclear program.

France's well-publicized efforts to rally the support of Muslim groups in France and the Middle East to free the journalists could all backfire. In early September, French Foreign Minister Michel Barnier criss-crossed the Middle East to meet with Muslim leaders, including Qatar-based Islamic televangelist Yusuf Al-Qaradawi, whose jeremiads against "infidels" and approval of suicide bombers have triggered harsh criticism from Muslim moderates. France also has enlisted the support of Iraqi groups opposed to the U.S.-backed regime. Bertrand Badie, a specialist on international relations at the Institute of Political Studies in Paris, thinks Paris is trying to capitalize on anti-American sentiment in the Arab world. "This is legitimizing nonstate actors and officially associating them in diplomatic activity," says Badie. "It's a risk." These tactics might eventually help secure the release of the hostages. Will they be a winning policy for the long-term? Evidence suggests not. ■



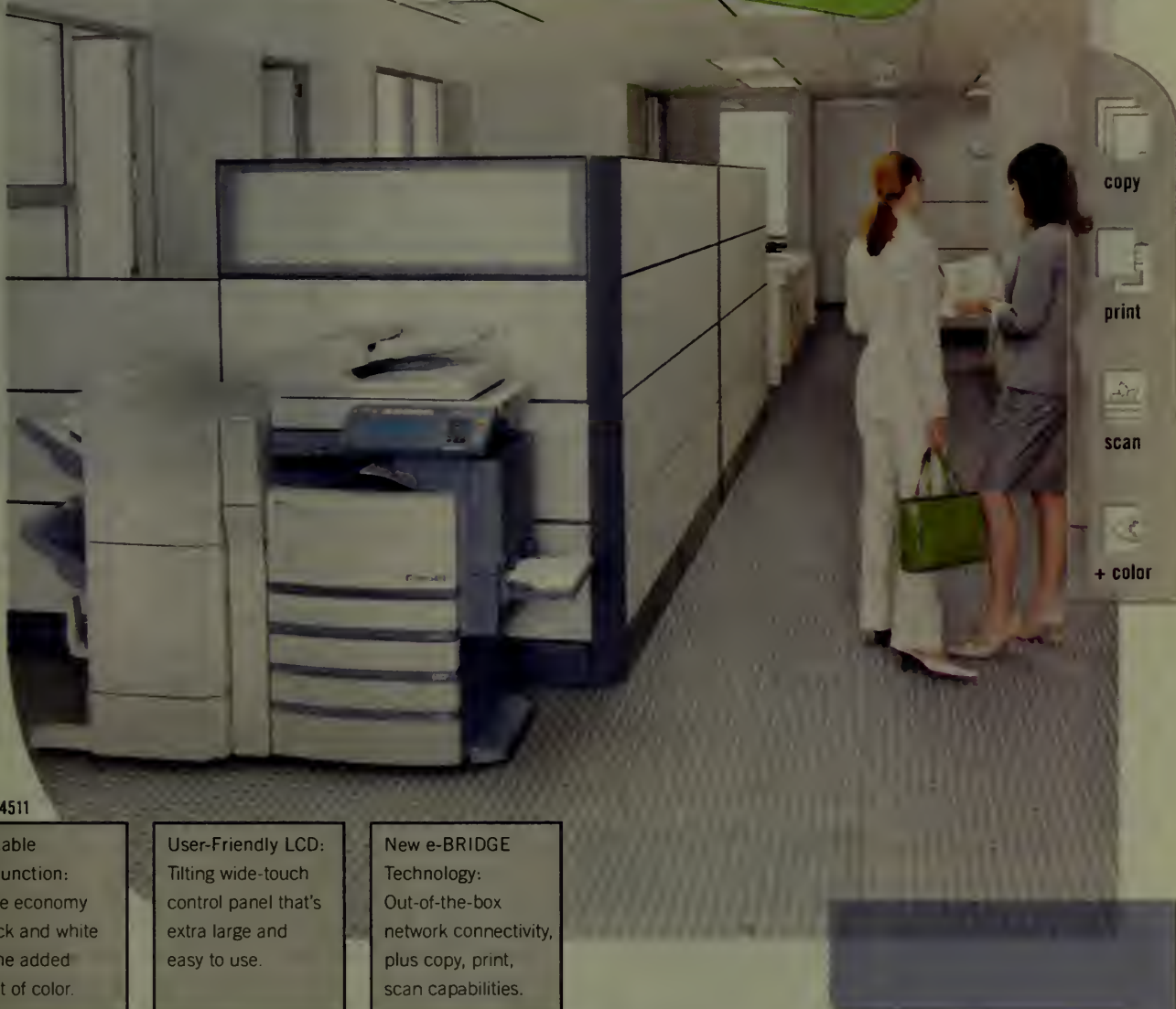
FRENCH STUDENT
The scarf ban is a flash point

Many Muslims are outraged by domestic policies in France

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CHINA

LETTING UP ON THE GAS

As Chinese sales slump, world carmakers dial back their forecasts

WHEN LI CHEN TOOK a job selling cars at the Kailong Pacific Buick dealership in Shanghai six months ago, work was a snap. Demand was so strong that people were willing to slap down \$40,000 in advance to get quick delivery of a Buick Regal sedan, and a hotshot salesman could close a deal in 30 minutes flat. These days, however, every sale is a tough slog. "More customers are looking instead of buying," says Li.

Li isn't the only one singing the showroom blues. Dealerships from Shenzhen to Shenyang are struggling to move cars as monthly sales have declined steadily since hitting an all-time peak in March. Year-on-year, sales grew just 6.8% in June and 2.5% in July—and August figures look even weaker. That's a big change from last year, when sales surged 76%, to 2.1 million cars, on top of 62% growth in 2002. "It has been a pretty ugly picture,"

says Philip F. Murtaugh, chairman of General Motors China Group. Although GM has fared well—its sales were up 56% in the first half—the summer months have fallen short of expectations. "We absolutely expected that growth would slow, but that it happened so quickly took people by surprise," Murtaugh says.

Why the downshift? Blame China's efforts to rein in its overheated economy. Although autos haven't been specifically targeted, the government's bid to restrict credit growth of all kinds has

hit car buyers hard. Today just 10% of car purchases are financed with loans, down from 35% a year ago, says consultancy Automotive Resources Asia Ltd. Manufacturers say dealers are also trimming inventory because banks are denying them loans they need for working capital. And government agencies and state-owned companies, which account for about 40% of auto sales, have cut back on buying.

AMBITIOUS PLANS

THE SLOWDOWN has come as a serious shock to foreign carmakers, who have been pinning their hopes for global growth on China. In the past year, top auto execs from Europe, the U.S., and Japan have flocked to the mainland to announce ambitious expansion plans. GM wants to spend \$3 billion by 2007 to double its production capacity in China, to 1.3 million cars and trucks, and it expects to introduce 20 new models over that time. Volkswagen, the country's largest carmaker, with 30% of the market, is stumping up \$6.3 billion to double capacity to 1.6 million Passats, Golfs, Audis, and other vehicles by 2008. And relative newcomer Ford Motor Co. plans to invest \$1 billion on expansion in China. Together, nine top international manufacturers plan to spend a total of \$9.7 billion in China between 2003 and 2007, doubling the country's

AUDI IN BEIJING

Parent Volkswagen, with 30% of the market, is hurting

production capacity to million passenger cars annually, according to consultancy A.T. Kearney Inc.

To keep the metal moving, auto makers have cut prices. In May, GM slashed nearly \$5,000 from the sticker price of its midsize Buick Regal sedan to \$35,900, and lopped \$3,500 off its most expensive GL8 executive wagon, to \$42,000. Volkswagen followed suit in June, cutting prices on seven models by as much as 11%. On Sept. 6, Hyundai announced across-the-board cuts of 10% which brought the price of its entry-level Elantra sedan as low as \$13,600.

It's too soon to tell whether the slowdown represents deeper problems that could force auto makers to reconsider their plans for China. The last time sales slumped, in early 2000, the market roared back after just three months. This time, though, there's far more capacity—and the government's push to rein in growth has just started. Still, executives and analysts insist there's no reason to doubt China's long-term potential. "It's just a bump in the road," says Yale Zhan, director for emerging markets at consultancy CSM Worldwide. In China, though, the potholes can be very deep. ■

—By Frederik Balfour in Shanghai



Stalled

After reaching an all time high in March, car sales in China have plunged

MARCH 2004

250,263

JULY 2004

184,296

Data: China Association of Automobile Manufacturers

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VIAGRA is prescribed to treat erectile dysfunction. We know that no medicine is for everyone. If you use nitrate drugs, often used for chest pain (known as angina), don't take VIAGRA. Taking these drugs together could cause your blood pressure to drop to an unsafe level.

The most common side effects of VIAGRA are headache, facial flushing, and upset stomach. Less common are bluish or blurred vision, or being sensitive to light. These may occur for a brief time. Remember to protect yourself and your partner from sexually transmitted diseases.

Talk with your doctor first. Make sure you are healthy enough to have sex. If you have chest pain, nausea, or other discomforts during sex, seek medical help right away. The same is true if you have an erection that lasts more than 4 hours. Call for help at once.

VIAGRA is covered under most Managed Care Plans.

* For some men, in as quickly as 10 minutes; for most, in under a half hour (statistical significance at 14 minutes). In this study, VIAGRA responders, given 100 mg 2 hours after eating, were timed to see how fast they got an erection that enabled them to have sex.

[†] Data on file. Pfizer Inc., New York, NY

Please see our patient summary of information for VIAGRA (25 mg, 50 mg, 100 mg) tablets on the following page.

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VIAGRA®

(sildenafil citrate) tablets

This summary contains important information about VIAGRA®. It is not meant to take the place of your doctor's instructions. Read this information carefully before you start taking VIAGRA. Ask your doctor or pharmacist if you do not understand any of this information or if you want to know more about VIAGRA.

This medicine can help many men when it is used as prescribed by their doctors. However, VIAGRA is not for everyone. It is intended for use only by men who have a condition called erectile dysfunction. **VIAGRA must never be used by men who are taking medicines that contain nitrates of any kind, at any time. This includes nitroglycerin. If you take VIAGRA with any nitrate medicine your blood pressure could suddenly drop to an unsafe or life threatening level.**

• What Is VIAGRA?

VIAGRA is a pill used to treat erectile dysfunction (impotence) in men. It can help many men who have erectile dysfunction get and keep an erection when they become sexually excited (stimulated).

You will not get an erection just by taking this medicine. VIAGRA helps a man with erectile dysfunction get an erection only when he is sexually excited.

• How Sex Affects the Body

When a man is sexually excited, the penis rapidly fills with more blood than usual. The penis then expands and hardens. This is called an erection. After the man is done having sex, this extra blood flows out of the penis back into the body. The erection goes away. If an erection lasts for a long time (more than 6 hours), it can permanently damage your penis. You should call a doctor immediately if you ever have a prolonged erection that lasts more than 4 hours.

Some conditions and medicines interfere with this natural erection process. The penis cannot fill with enough blood. The man cannot have an erection. This is called erectile dysfunction if it becomes a frequent problem.

During sex, your heart works harder. Therefore sexual activity may not be advisable for people who have heart problems. Before you start any treatment for erectile dysfunction, ask your doctor if your heart is healthy enough to handle the extra strain of having sex. If you have chest pains, dizziness or nausea during sex, stop having sex and immediately tell your doctor you have had this problem.

• How VIAGRA Works

VIAGRA enables many men with erectile dysfunction to respond to sexual stimulation. When a man is sexually excited, VIAGRA helps the penis fill with enough blood to cause an erection. After sex is over, the erection goes away.

• VIAGRA Is Not for Everyone

As noted above (*How Sex Affects the Body*), ask your doctor if your heart is healthy enough for sexual activity.

If you take any medicines that contain nitrates — either regularly or as needed — you should never take VIAGRA. If you take VIAGRA with any nitrate medicine or recreational drug containing nitrates, your blood pressure could suddenly drop to an unsafe level. You could get dizzy, faint, or even have a heart attack or stroke. Nitrates are found in many prescription medicines that are used to treat angina (chest pain due to heart disease) such as:

- nitroglycerin (sprays, ointments, skin patches or pastes, and tablets that are swallowed or dissolved in the mouth)
- isosorbide mononitrate and isosorbide dinitrate (tablets that are swallowed, chewed, or dissolved in the mouth)

Nitrates are also found in recreational drugs such as amyl nitrate or nitrite ("poppers"). If you are not sure if any of your medicines contain nitrates, or if you do not understand what nitrates are, ask your doctor or pharmacist.

VIAGRA is only for patients with erectile dysfunction. VIAGRA is not for newborns, children, or women. Do not let anyone else take your VIAGRA. VIAGRA must be used only under a doctor's supervision.

• What VIAGRA Does Not Do

- VIAGRA does not cure erectile dysfunction. It is a treatment for erectile dysfunction.
- VIAGRA does not protect you or your partner from getting sexually transmitted diseases, including HIV — the virus that causes AIDS.
- VIAGRA is not a hormone or an aphrodisiac.

• What To Tell Your Doctor Before You Begin VIAGRA

Only your doctor can decide if VIAGRA is right for you. VIAGRA can cause mild, temporary lowering of your blood pressure. You will need to have a thorough medical exam to diagnose your erectile dysfunction and to find out if you can safely take VIAGRA alone or with your other medicines. Your doctor should determine if your heart is healthy enough to handle the extra strain of having sex.

Be sure to tell your doctor if you:

- have ever had any heart problems (e.g., angina, chest pain, heart failure, irregular heart beats, heart attack or narrowing of the aortic valve)
- have ever had a stroke
- have low or high blood pressure
- have a rare inherited eye disease called retinitis pigmentosa
- have ever had any kidney problems
- have ever had any liver problems
- have ever had any blood problems, including sickle cell anemia or leukemia
- are allergic to sildenafil or any of the other ingredients of VIAGRA tablets
- have a deformed penis, Peyronie's disease, or ever had an erection that lasted more than 4 hours
- have stomach ulcers or any types of bleeding problems
- are taking any other medicines

• VIAGRA and Other Medicines

Some medicines can change the way VIAGRA works. Tell your doctor about **any medicines** you are taking. Do not start or stop taking any medicines before checking with your doctor or pharmacist. This includes prescription and nonprescription medicines or remedies:

- Remember, VIAGRA should never be used with medicines that contain nitrates (see *VIAGRA Is Not for Everyone*).
- If you are taking alpha-blocker therapy for the treatment of high blood pressure or prostate problems, you should not take a dose of greater than 25 mg of VIAGRA at the same time (within 4 hours) as you take your dose of alpha-blocker.
- If you are taking a protease inhibitor, your dose may be adjusted (please see *Finding the Right Dose for You*).
- VIAGRA should not be used with any other medical treatments that cause erections. These treatments include pills, medicines that are injected or inserted into the penis, implants or vacuum pumps.

• Finding the Right Dose for You

VIAGRA comes in different doses (25 mg, 50 mg and 100 mg). If you do not get the results you expect, talk with your doctor. You and your doctor can determine the dose that works best for you.

- Do not take more VIAGRA than your doctor prescribes.
- If you think you need a larger dose of VIAGRA, check with your doctor.
- VIAGRA should not be taken more than once a day.

If you are older than age 65, or have serious liver or kidney problems, your doctor may start you at the lowest dose (25 mg) of VIAGRA. If you are taking protease inhibitors, such as for the treatment of HIV, your doctor may recommend a 25 mg dose and may limit you to a maximum single dose of 25 mg of VIAGRA in a 48 hour period. If you are taking alpha-blocker therapy, you should not take a dose of greater than 25 mg of VIAGRA at the same time (within 4 hours) as your dose of alpha-blocker.

• How To Take VIAGRA

Take VIAGRA about one hour before you plan to have sex. Beginning in about 30 minutes and for up to 4 hours, VIAGRA can help you get an erection if you are sexually excited. If you take VIAGRA after a high-fat meal (such as a cheeseburger and french fries), the medicine may take a little longer to start working. VIAGRA can help you get an erection when you are sexually excited. You will not get an erection just by taking the pill.

• Possible Side Effects

Like all medicines, VIAGRA can cause some side effects. These effects are usually mild to moderate and usually don't last longer than a few hours. Some of these side effects are more likely to occur with higher doses. The most common side effects of VIAGRA are headache, flushing of the face, and upset stomach. Less common side effects that may occur are temporary changes in color vision (such as trouble telling the difference between blue and green objects or having a blue color tinge to them), eyes being more sensitive to light, or blurred vision.

In rare instances, men have reported an erection that lasts many hours. You should call a doctor immediately if you ever have an erection that lasts more than 4 hours. If not treated right away, permanent damage to your penis could occur (see *How Sex Affects the Body*).

Heart attack, stroke, irregular heart beats, and death have been reported rarely in men taking VIAGRA. Most, but not all, of these men had heart problems before taking this medicine. It is not possible to determine whether these events were directly related to VIAGRA.

VIAGRA may cause other side effects besides those listed on this sheet. If you want more information or develop any side effects or symptoms you are concerned about, call your doctor.

• Accidental Overdose

In case of accidental overdose, call your doctor right away.

• Storing VIAGRA

Keep VIAGRA out of the reach of children. Keep VIAGRA in its original container. Store at 25°C (77°F); excursions permitted to 15-30°C (59-86°F) [see USP Controlled Room Temperature].

• For More Information on VIAGRA

VIAGRA is a prescription medicine used to treat erectile dysfunction. Only your doctor can decide if it is right for you. This sheet is only a summary. If you have any questions or want more information about VIAGRA, talk with your doctor or pharmacist, visit www.viagra.com, or call 1-888-4VIAGRA.



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September 2002

EDITED BY PATRICIA KRANZ

After the Massacre: No Fast Fixes for Putin

AS MANY AS 100,000 RUSSIANS gathered near the Kremlin on Sept. 7 to protest the Beslan attack, where at least 335 died. In Moscow and many other cities across Russia, protesters are focusing most of their anger on the perpetrators. But Russian President Vladimir V. Putin could take hits, too, for not doing enough

to protect the country from terrorists. Putin himself admitted in a national address on Sept. 4 that the armed forces and security services need to be revamped. Liberals in Russia and the West say Putin should be doing more to stop the violence by negotiating a political settlement in Chechnya. "Will the President agree to a fundamental revision of his policy in Chechnya?" independent Duma deputy Vladimir Ryzhkov asked in Moscow daily *Nezavisimaya Gazeta* on Sept. 6.

Limited Options

THE TROUBLE IS, even if Putin wanted to pursue a peaceful settlement, his options to end the violence are limited. For one thing, the terrorists' primary aim isn't independence for Chechnya. "The main goal was to punish Putin. Another goal was to destabilize the whole situation in the North Caucasus and southern Russia," says Alexei Malashenko, a Caucasus expert from the Carnegie Center in Moscow. By triggering revenge attacks on Muslims in the neighboring republic of Ingushetia, the terrorists hope to win converts to the extremist cause.

Besides, the militants have little sympathy among most Chechens. According to Sergei Khaikin of the Institute for Social Marketing in Moscow, which conducts regular surveys of Chechen public opinion, a mere 2% to 3% of the population support rebel leader Aslan Maskhadov, compared with 80% who want Chechnya to remain in Russia. "It's not that they love the Russians," he says. "They think that it's simply more advantageous to live

with Russia." So if the Russians were to hold talks with the groups responsible for the Beslan massacre, Moscow would just alienate the Chechen majority.

Moscow, of course, has complicated the task of finding a way out by waging two brutal wars. But even before Russia's 1999 invasion, the Chechen separatist movement had largely been taken over by Islamic extremists with little public support. The U.S. State Department says three Chechen groups controlled by rebel warlord Shamil Basayev have "numerous and longstanding linkages to each other and to al Qaeda, with Osama bin Laden and the Taliban." Maskhadov, Chechnya's former President, says he opposes

Basayev's methods. But even if Moscow did negotiate with Maskhadov, analysts say he has little power over rebels such as Basayev.

What else could Putin do? The President could take steps to broaden the Chechen political process, thus strengthening the legitimacy of local government and weakening

whatever remaining support the rebels have. Perhaps most important, the North Caucasus region needs economic development. Although Moscow sends increasing amounts of reconstruction aid, most of it is stolen by corrupt officials. Better would be grassroots measures to promote small-scale enterprise. Over time greater political participation and economic revival could help reduce the social alienation that swells the ranks of militants. It would be naive to think, though, that such measures would have an immediate effect. The tragic reality is that Russia is likely to suffer from terrorist attacks and ethnic conflict for years to come. ■

—By Jason Bush in Moscow



PUTIN
Whom would he negotiate with?

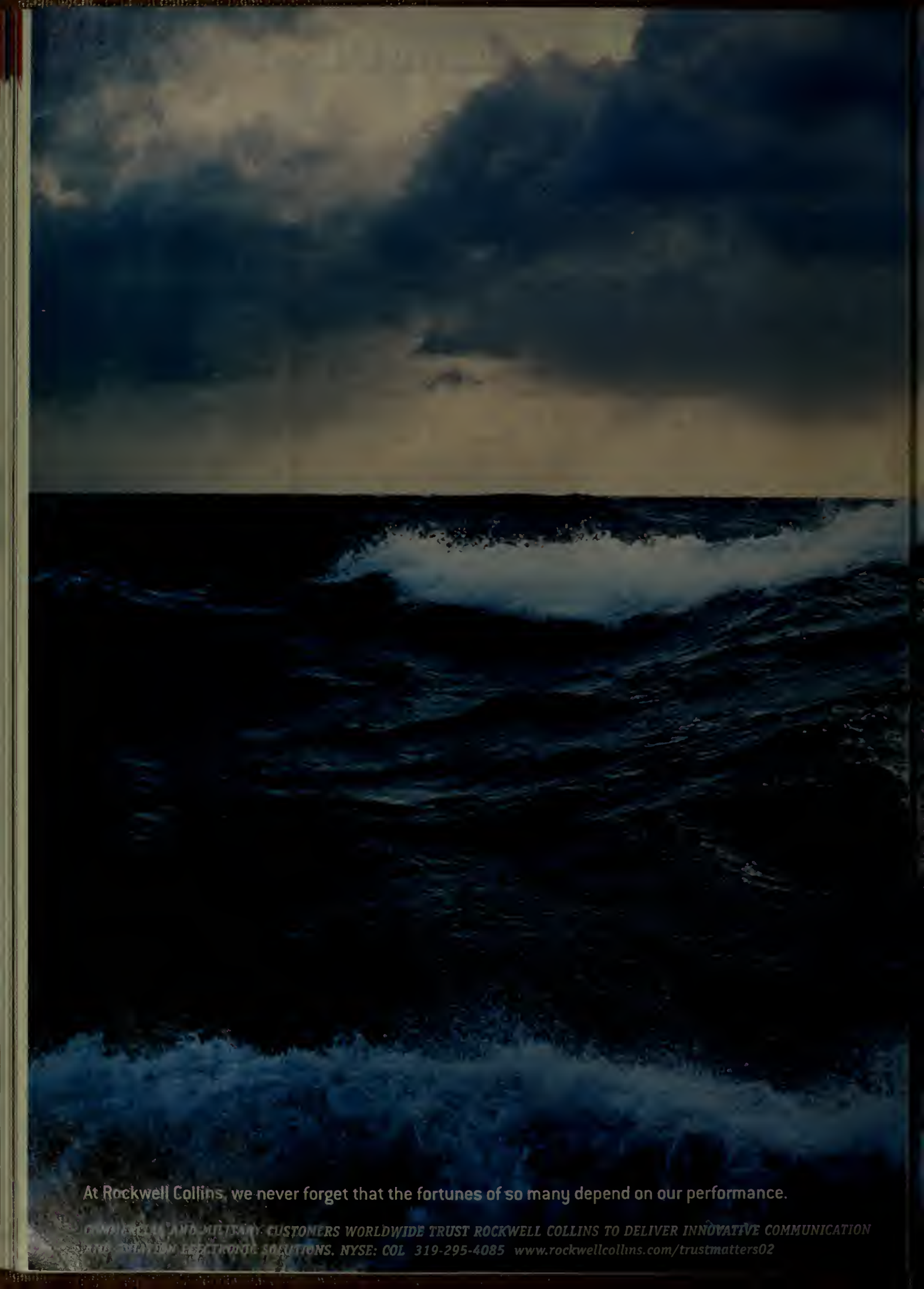
GLOBAL WRAPUP

GERMANY: A SETBACK FOR SCHRODER

THE SEPT. 5 STATE Parliament elections in Germany's Saarland were a disaster for Chancellor Gerhard Schröder's Social Democratic Party (SPD). The Social Democrats' share of the vote in their onetime stronghold plummeted 13.6 percentage points, to 30.8%. But despite what the pundits are writing, the poll wasn't necessarily a popular outcry against economic reform. Yes, unemployed and working-class voters deserted the SPD ahead of cuts in jobless benefits. But the pro-reform Green Party and Free Democrats gained ground, while Christian Democratic Saarland Minister-President Peter Müller—a noted reformer who has cut bureaucracy and streamlined public education—expanded his majority in the state Parliament by winning 47.5% of the votes. As further elections approach in Brandenburg and Saxony on Sept. 19, the Saarland vote shows Germans may not be as fearful of change as some polls think.

A BBC UNIT MAY BE HEADED FOR THE BLOCK

IS THE BEEB'S international cousin looking for a buyer? Britain's publicly funded British Broadcasting Corp. confirmed on Sept. 8 that it is talking to media giants such as Bertelsmann, Time Warner, and Walt Disney about the future of its commercial arm, BBC Worldwide. If sold, the unit's businesses—which include international distribution of programs such as *The Office*, cable channel BBC America, and magazines, books, and videos—could fetch as much as \$3.6 billion. Four investment banks are advising the BBC, but it stresses that no decision to sell has been made.



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The Signs They Are A-Changin'

Startup Magink's "digital ink" may change everything from billboards to laptops

TO SPORTS FANS, GIANT TV-like displays have become old hat. Huge screens composed of thousands of light-emitting diodes (LEDs) treat fans to instant replays and sparkling, computer-generated graphics at Yankee Stadium, Houston Astrodome, Los Angeles Memorial Coliseum, and dozens of other stadiums. Similar LED signs, many supplied by Japan's Mitsubishi Electric Corp., help to light up New York's Times Square and the Las Vegas Strip.

A slim new Mitsubishi sign, however, is neither an LED screen nor a king-size liquid-crystal display (LCD) panel. It has a paperlike surface sporting a breakthrough "digital ink" from Magink Display Technologies Inc., an Israeli startup now based in New York. Mitsubishi is Magink's manufacturing partner. It's not the only heavy hitter in Magink's corner. In July, it picked up \$27 million from a group led by VantagePoint Venture Partners in Silicon Valley. The money will be used to bring Magink's technology to the U.S.

What's the big deal? Magink's digital ink is the first to offer a full spectrum of colors. It's a pasty concoction that, smeared on a thin sheet of plastic or glass, can replace LEDs in monster displays or small LCDs in electronic products. To VantagePoint partner Duncan Davidson, Magink's ink is "extraordinary technology" that promises a revolution in displays, starting with outdoor advertising—a \$5 billion U.S. business.

The initial cost of a 10-by-20-foot Magink billboard will probably run

around \$50,000. That's not cheap compared with the \$10,000 cost of a conventional display, but it's a bargain compared with the \$500,000-and-up price of an LED screen that size.

More important to billboard owners, says Magink CEO Ran Poliakine, is return on investment. Digital ink can end the cost of printing paper ads and manually plastering them on billboards—and create a new revenue stream: selling variably priced time-slot ads, just as TV stations do. Poliakine figures that by charging a premium for rush-hour ads, a billboard could rake in 10 times more money. The same goes for placards in trains and buses, mass-transit stations, and elsewhere. "With today's billboards, you can't announce Lotto winners minutes after the drawing," he notes. "With Magink, you can."

Magink's secret is a blend

of organic molecules that produces a paste consisting of tiny structures resembling the DNA helix. Each helix is about one micron long and responds in a predictable way to signals from a control grid on the plastic or glass substrate. Under white light, the helixes normally look red. But send a certain signal from a computer to a specific grid junction, and the helixes there change shape slightly and turn blue. Other signals produce green, yellow, or other hues. The screen can be repainted 70 times a second—double the speed for full-motion video—or an image can be frozen for months without fading. "The technology really does work like magic," says Poliakine.

THE COLOR OF MONEY

JAPAN IS ALREADY feeling the magic. Mitsubishi is installing Magink information displays at highway rest stops and roadside tourist centers. They provide news, a list of local attractions, and traffic and weather conditions for the next 100 miles. Each sign can be updated instantly via a wireless transmission, says Poliakine. Similarly, Japan Railway Group can press a "send" button and update all of its Magink timetable displays on train platforms.

Magink isn't the only digital ink on the market. Last March, Royal Philips Electronics and Sony Corp. unveiled an electronic book with a paperlike display. It uses the ink developed by E Ink Corp. in Cambridge, Mass. But this ink, like those in the works at Gyricon, IBM, and Siemens, is only black and white. "Other companies just haven't gotten over the full-color hurdle," boasts Poliakine. By winning that race, tiny Magink may light up the countryside like Broadway. ■

—By Otis Port in New York

Sony and IBM have the ultrathin technology, but not in color



TOKYO DEMO
Large digital ink displays cost far less than LEDs



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Demand-driven supply network

Manufacturers have long planned their operations based on factory capacity and asset utilization. By reviewing what sold in the past and factoring in production capacity for a given time frame, companies plan and execute their production strategies — then they “push” the resulting goods to their customers.

But some leading companies are taking a new view: allowing customer demand to drive supply chain planning and execution. This approach, what AMR Research calls the “demand-driven supply network,” or DDSN, uses a system of technologies and processes to sense demand and react to it in real time, across a network of linked customers, suppliers, and employees. The financial results can be dramatic. What’s more, DDSN pioneers also develop superior responsiveness that enables them to take advantage of market opportunities and, in some cases, disable or crush their competitors.

“Leading companies are embracing DDSN,” explains Greg Aimi, research director of the supply-chain management practice at AMR Research Inc., in Boston. “They realize that this is how they can deliver a higher-margin product to their customers, with less working capital, greater profits, and increased earnings per share. And that’s pretty compelling!”

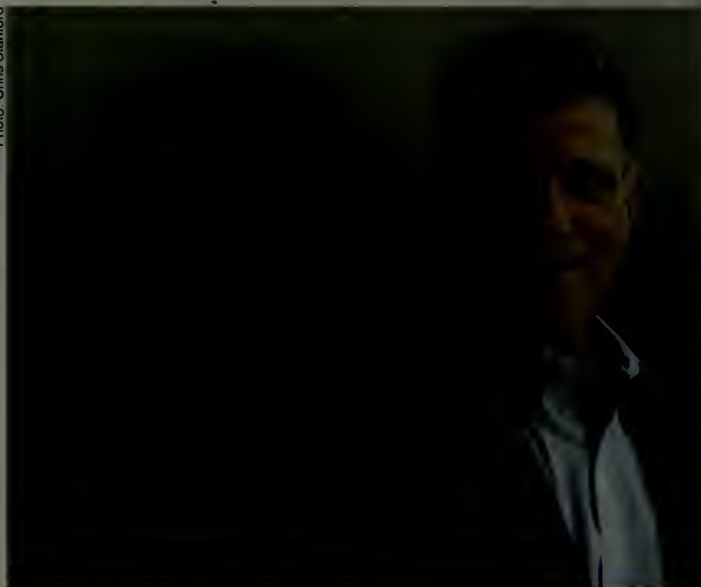
In fact, a recent study by AMR Research revealed that companies that excel at demand forecasting, called leaders in the report, have 15% less inventory, 17% stronger order fulfillment, and 35% shorter cash-to-cash cycle times than typical companies. In addition, achieving a balance between the cost and service tradeoffs of supply chain excellence nets companies 60% better profit margins and two to three times the return on assets achieved by “laggards.”

DDSN is not just about financial improvement; it also helps companies better serve their customers. Rexam, a top-five global consumer packaging giant based in London, is incorporating customer demand signals in its supply chain.

“It’s very important that we add value to our customers’ operations and take cost out.” — Bo-Inge Stensson, Rexam

With customers such as Coca-Cola, Heineken, L’Oréal, Bacardi, and Nestlé, the \$4.3 billion company runs operations in more than 100 facilities, serving five business sectors in more than 20 countries. The company also is the largest beverage can manufacturer in the world. “All customers today want more for less,” says Bo-Inge Stensson, global supply chain director for Rexam. “It’s very important that, whatever we do, we add value to our customers’ operations and take cost out. As part of that effort, we are developing different supply

Photo: Chris Stanford



DDSNs can improve overall company performance, says Pete Sinisgalli, CEO of Manhattan Associates.

chain strategies to support different customer segments to add value to the customer.”

GOING FOR THE GOLD IN SCM

So what exactly is DDSN, and how does it differ from traditional supply chain orientations? AMR Research characterizes DDSN as “a supply chain driven by the voice of the customer,” a next-generation supply chain that is built to serve “the downstream source of demand rather than the upstream supply

constraints of factories and distribution systems.” It tightly links the management of demand with that of supply and product, allowing manufacturers to understand and act on changes in each area at once.

The Holy Grail of DDSN is a company’s ability to deliver the so-called perfect order — an order that arrives with the right goods, at the right time, in the right place. The perfect order delivers optimum customer satisfaction, which in turn improves business metrics.



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"The benefit of a demand-driven solution is an improved overall company performance," says Pete Sinisgalli, CEO of Manhattan Associates Inc., a maker of supply-chain execution and optimization software based in Atlanta. "Companies that do this achieve better customer satisfaction, higher profitability, and

that the spot improvements made in the last 10 to 15 years to supply chain operations are not enough to sustain a competitive advantage in today's economy," says Carol A. Ptak, vice president and global industry executive for manufacturing and distribution industries at PeopleSoft Inc.,

"Companies can become more nimble as they develop a flexible ability to deliver on demand." — Greg Aimi, AMR Research

lower capital investment in undesirable inventory. Those are all benefits of being able to listen and react more quickly to specific customer demand. As opposed to historical supply chain solutions that improved a business process within the supply chain, the appeal of demand-driven solutions starts with the customer."

Not working to create the perfect order also has consequences. "Companies that are not focused on the needs of their customers run the risk of having the wrong products in the wrong place at the wrong time," says Jim Ritchie, CEO of Meridian IQ, Inc., a global-logistics management unit of Yellow Roadway Corp., in Overland Park, Kan. "If you can create more of a customer-demand driven supply chain and you can respond to

Pleasanton, Calif. "Operational improvements deliver only a short-term, one-shot benefit. But when you exploit that capability that you've developed internal to your four walls and use it to provide value to your customer — at a profit to yourself — that's what delivers the big 'wow!'" (In fact, Ptak says that many companies that have successfully incorporated DDSN approaches are reluctant to discuss their resulting improvements — not because they are afraid of sharing competitive secrets, but because the benefits are so huge, they fear no one will believe them.)

Making the transition from planning according to what's best for the factory to planning to meet customer demand is no small adjustment, though. "This is a change in orientation," says AMR Research's Aimi. "It's a business process change for many companies that requires them to break down the silos within the organization so they can collaborate between sales, logistics, procurement, and operations." The proficiency with which companies execute DDSN can be measured in four stages: beginners that have almost no integration along the supply chain; companies whose enterprise is connected internally; enterprises connected externally to business partners with which they are beginning to collaborate; and companies with multi-tier integration, which supports demand visibility and supply chain collaboration.

The transition to DDSN is made more complex by the increasing use of global outsourcing practices in many manufacturing segments. When components or assemblies are outsourced to suppliers, the degree of complexity multiplies exponentially — after all, your supplier's suppliers can affect your ability to meet customer demand. Electronics manufacturers, for example, have extremely complex supply chains in which they subcontract operations to suppliers and contract manufacturers around the world.

"As companies outsourced their production to contract manufacturers while needing to maintain relationships with key component suppliers behind them, supply chains became much more complex," says Chris Smith, CEO of RiverOne Inc., an Irvine (Calif.) provider of supply-chain management software to manufacturers. "The value-added contributions to the final product come from more companies.



In DDSN, production must be tightly linked to supply and demand.
Source: AMR Research 2004

market dynamics more quickly, you can reposition the right products in the right place at the right time. That delivers not just a market advantage, but a superior financial advantage as well."

CREATING A WELL-COORDINATED TEAM

Companies are clearly interested in incorporating demand into their SCM planning and execution. "Customers are recognizing



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As a result, there is a real gap in the market in understanding how to put supply chains back together and make them run smoothly again."

Another concern, especially in the transportation and logistics end of the supply chain, is the need for speed and efficiency—especially across the global network. "With the advent of global sourcing, the supply chain is now longer," says Ritchie from Meridian IQ. "Shipments often must travel farther distances in shorter amounts of time, with greater predictability and visibility."

The demand-driven concepts represented by DDSN extend beyond just parts and material goods; some companies

INFORMATION IS POWER

Rexam, the consumer packaging company, understands that making the change to DDSN requires a comprehensive strategy buoyed by information technology. The company recently entered into a strategic partnership with software maker SAP AG, based in Walldorf, Germany, to use tools that would help the company integrate upstream and downstream, with both customers and suppliers.

"To make this work, we must create visibility in real time," says Stensson. "When an event is triggered downstream with our customer, we must know it—but so must our suppliers and our suppliers' suppliers." Without

"Shape your strategy to meet your customers' needs, and you won't go wrong." —Carol A. Ptak, PeopleSoft

apply them to the human resources that contribute to the creation of a deliverable. "Even project-based service companies need to place the right human resources at the right place at the right time," explains Rick Lowrey, executive vice president of Deltek, a software developer for project-based businesses and professional service firms, based in Herndon, Va. "These companies also need to deploy critical resources in a real-time mode."

this information, partners throughout the supply chain can experience a bullwhip effect, in which disruptions intensify throughout the chain. This can negatively affect cash-to-cash cycle time.

Rexam is taking another key step: working to understand the business processes that make up the supply chain interactions with its suppliers and customers. "When you try to integrate with your customers and suppliers in the supply

SUPPLY CHAIN CLARITY A VIEW ON FLEXTRONICS' SUCCESS

Supply chain complexity has multiplied exponentially in all markets, but nowhere is the mix of design, manufacturing, and assembly more intricate—and delicately balanced—than in the electronics industry. With global outsourcing splintering manufacturing processes into ever-smaller specialties, partners in an electronics supply chain require unprecedented levels of collaboration and communication.

At Flextronics, the world's leading electronics manufacturing services (EMS) provider, headquartered in Singapore, achieving a better understanding of volatile fluctuations in customer demand has contributed to its success. The \$14.5 billion global company, which contracts with as many as 2,500 suppliers in 32 countries, coordinates design, engineering, manufacturing, and logistics operations across its network for leading original equipment manufacturers (OEMs). "We needed to collaborate with our suppliers regarding our requirements in a more efficient way," says Mike Webb, CIO for Flextronics. "By continuously becoming more agile and reacting more quickly when customer demand changed, we could reduce customer supply chain costs and avoid predicaments with excess inventory."

Flextronics worked with RiverOne Inc., an Irvine (Calif.) provider of supply-chain management software for manufacturers, to develop a new tool: FLEXPASS, a clear, integrated technology platform that enables Flextronics to collaborate

quickly and easily with its supply chain partners. FLEXPASS links RiverOne technology with Flextronics' enterprise resource planning systems. The result is an environment where suppliers can view demand changes, adjust production plans, and share information about delivery dates and volumes.

"With FLEXPASS, we've enhanced our supply chain clarity," says Webb. "The platform clearly indicates changes in requirements in a very timely manner, sending messages to our supply chain partners that keep everyone informed." Currently more than 700 of Flextronics' suppliers are linked to FLEXPASS, with the remainder scheduled to come on line in the next year. Although specific business improvement metrics are confidential, Webb confirms that the platform has delivered substantial benefit to Flextronics.

"Materials management is one of the most important cost considerations in the success of our manufacturing operations," he says. "FLEXPASS has provided tremendous value by enhancing our communication with our customers and business partners and avoiding unnecessary costs."

Photo: David Toerge



By reacting more quickly to changing customer demand, Flextronics is reducing supply chain costs and excess inventory, says Mike Webb, CIO.

chain, you need to understand the business processes and try to optimize the future state," he says. "That is extremely important. Otherwise, you can find yourself automating bad processes." Rexam is using Lean Enterprise and Six Sigma management initiatives to align supply chain processes.

Aimi of AMR Research argues that the first step in making a successful transition to demand-driven supply chain practices is to develop corporate supply-chain strategies at the executive level. Company leaders must focus on gathering more detailed demand-oriented information, and breaking down the silos that separate departments is a first step. Establishing a sales and operational planning (S&OP) team that meets frequently to share this information can help a company integrate the planning of production, procurement, logistics, and sales information. This in turn will help the organization orchestrate the company's delivery capacity so that it matches customer demand.

The second step is to understand or create cross-functional best practices that frequently review and assess production against demand. A typical planning window might be 120 days. When production is planned to meet demand, the time frame shrinks to monthly, weekly, or even more frequently. "In this way, companies can become more nimble as they develop a flexible ability to deliver on demand," Aimi says.

GET THE RIGHT GEAR

Although the shift to demand-driven supply chain processes is not strictly a technology fix, there are software and tools that can support the transition. According to AIM Global, a trade association for automatic identification and mobility, radio frequency identification (RFID) is the next step in reading demand signals closer to product consumption. Enterprise resource planning vendors are using their strengths in transaction processing to support information exchange among companies across the supply network.

Whichever technology you consider, it makes sense to look for one with the flexibility to serve not only today's needs, but also tomorrow's. Look for a technology that is flexible and adaptable. The architecture should be open and standards-based, which will allow a company to add and subtract components as needs change.

It's not necessary, however, to buy and implement all the supporting technology at once. "If you choose a modular solution, you can pick the parts that will have the greatest impact on your supply chain operation and implement them over time," explains Sinisgalli of Manhattan Associates. "As each area of the supply chain is optimized, the savings generated can be used to fund the next area."

It is critical, though, to make sure each component can be integrated into a uniform whole — parts that communicate with one another and that provide visibility across the enterprise.



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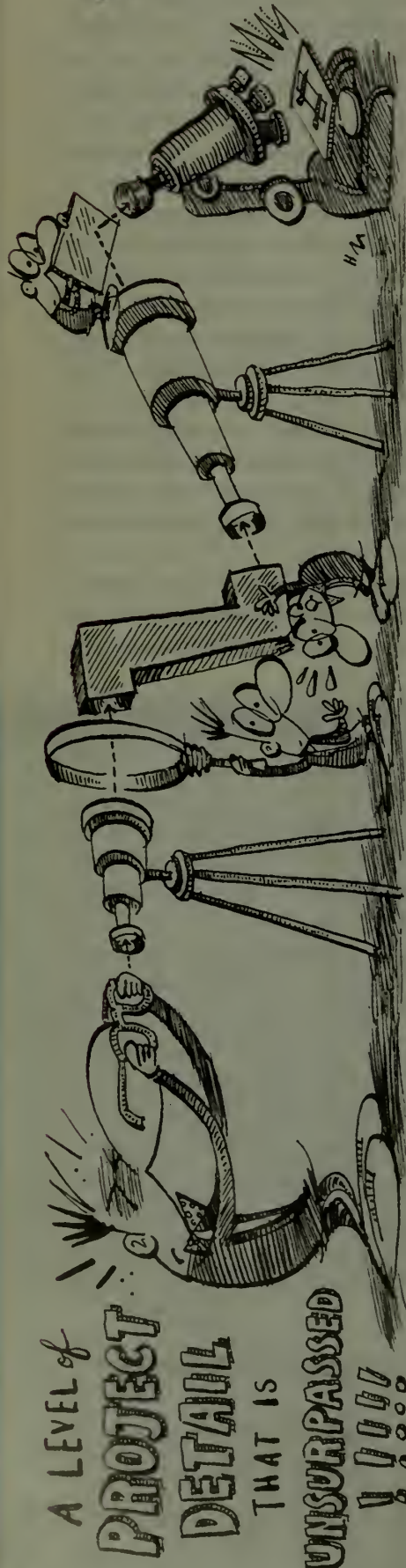
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Outsourced manufacturing is increasing the complexity of supply chains, says Chris Smith, CEO of RiverOne.

"Many companies find themselves with solutions that have been cobbled together over time," he adds. "These do not easily provide either visibility or optimization."

PLAY TO YOUR STRENGTHS

Companies may also want to involve their customers and business partners in determining which changes to make. "You can ask your customers what they are comfortable with in terms of providing access and sharing information to satisfy their needs," says Smith of RiverOne. "With the right foundation in place, you can build incrementally, growing with

your customers as their needs change — and contribute to your own success."

One caveat: there is no fixed formula for creating a DDSN that will work for every company. Just as each organization has individual goals and strengths, the strategies for incorporating demand signals into the supply chain must be customized. "Software companies may try to push the idea that there is one 'right' answer, but the reality is that each organization is unique," says Ptak of PeopleSoft. "Concentrate on shaping your strategy to meet your customers' needs, and you won't go wrong."

At Rexam, the work of shaping its supply chain operations to be more demand-oriented continues. The company has adopted strategic projects to be executed enterprise-wide, and it is also investigating the use of new technologies, like RFID, in small pilot implementations. "We are constantly looking for areas where we can add more value to our customers," says Stensson. "The consolidation of the markets means that supply chains compete, not companies. It's very important to create alliances with your customers. Our goal is to integrate more and more into the customers' planning systems. It's the only way to succeed in the current environment."

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The Wily Fox Behind Grey Goose

Sidney Frank made a killing on vodka. Next up: Wine and cognac



LIQUOR IMPORTER SIDNEY Frank enjoys referring to himself as “the \$2 billion man.” It’s a perfectly apt handle, considering he sold one of his top-selling brands, Grey Goose Vodka, to Bacardi Ltd. for more than that sum in June. It was the latest triumph for the chief executive of Sidney Frank Importing Co., who earlier made an improbable hit out of Jägermeister Herbal Liqueur. But at 84, Frank isn’t just basking in the glow of his good fortune. Between handing out millions to eclectic charities and trailing the golf pros he keeps on staff, the gleefully quirky octogenarian is plotting his next conquest. “I’d like to be the \$10 billion man!” he shouts.

Flush with capital, Sidney Frank Importing’s growth may well move as fast as its owner’s mouth. The New Rochelle (N.Y.) company will soon announce that it is launching a line of five Sicilian wines,

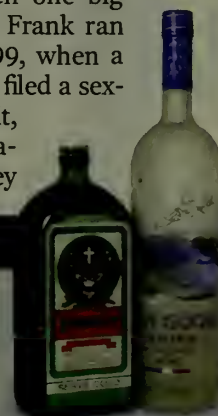
called the Sidney Frank Collection. Frank will name one of them Genofranco, after his brother and business partner, Eugene, who died last year. Then there is a plan for 50-proof cognac in flavors such as apple, pear, and orange, which he aims to call Tippet—the nickname of his first wife, Louise Rosenstiel, who died of a heart attack in the early 1970s. Privately, he is developing an energy drink, as well.

If Frank’s 32-year track record is any indication, he’ll back those names with some of the most innovative marketing techniques in the industry. Take Jägermeister. To promote the obscure licorice-flavored German liqueur, he hired some shapely women, dubbed Jägerettes, to hit bars and talk up the brand. Now, there are about 1,200 Jägerettes and Jägerdudes

GLEEFUL AT 84
“I’d like to be the \$10 billion man,” shouts Frank

nationwide. He also increased the drink’s appeal by developing a tap machine to bring the liqueur down to an icy 5F. “I never liked the stuff,” says longtime distributor and Chicago Blackhawks owner William W. Wirtz. “Then, Frank pulls out this machine, like a mad professor, and all of a sudden it’s very palatable.” Frank sold 500 cases of the drink when he began importing it in 1974, and he expects sales of 1.7 million this year.

It hasn’t all been one big frat party, though. Frank ran into trouble in 1999, when a group of Jägerettes filed a sexual harassment suit, claiming that patrons in the bars they



BIO

Sidney Frank

His new drinks should get the same marketing love he showered on Grey Goose

BORN Oct. 2, 1919, in Montville, Conn.

EDUCATION Dropped out of Brown University because of scarce funds and low grades.

CURRENT POSITION Chairman and CEO, Sidney Frank Importing Co.

CAREER HIGHLIGHTS Using a patented cooling technology and sexy

salesgirls, he turned the obscure German liqueur Jägermeister into a cult favorite. Bought France’s Grey Goose premium vodka and made it a hit, then sold it to Bacardi for more than \$2 billion in June.

CAREER LOW Paid out \$2.6 million in 1999 to settle a sexual harassment suit brought by more than 100

“Jägerette” spokesmodels. He denies any wrongdoing.

FAMILY Widowed, two children; married to second wife, Marian, for 27 years.

INDULGENCES Keeps four professional golfers on staff at an annual cost of \$400,000, just to watch them play; employs four chefs.



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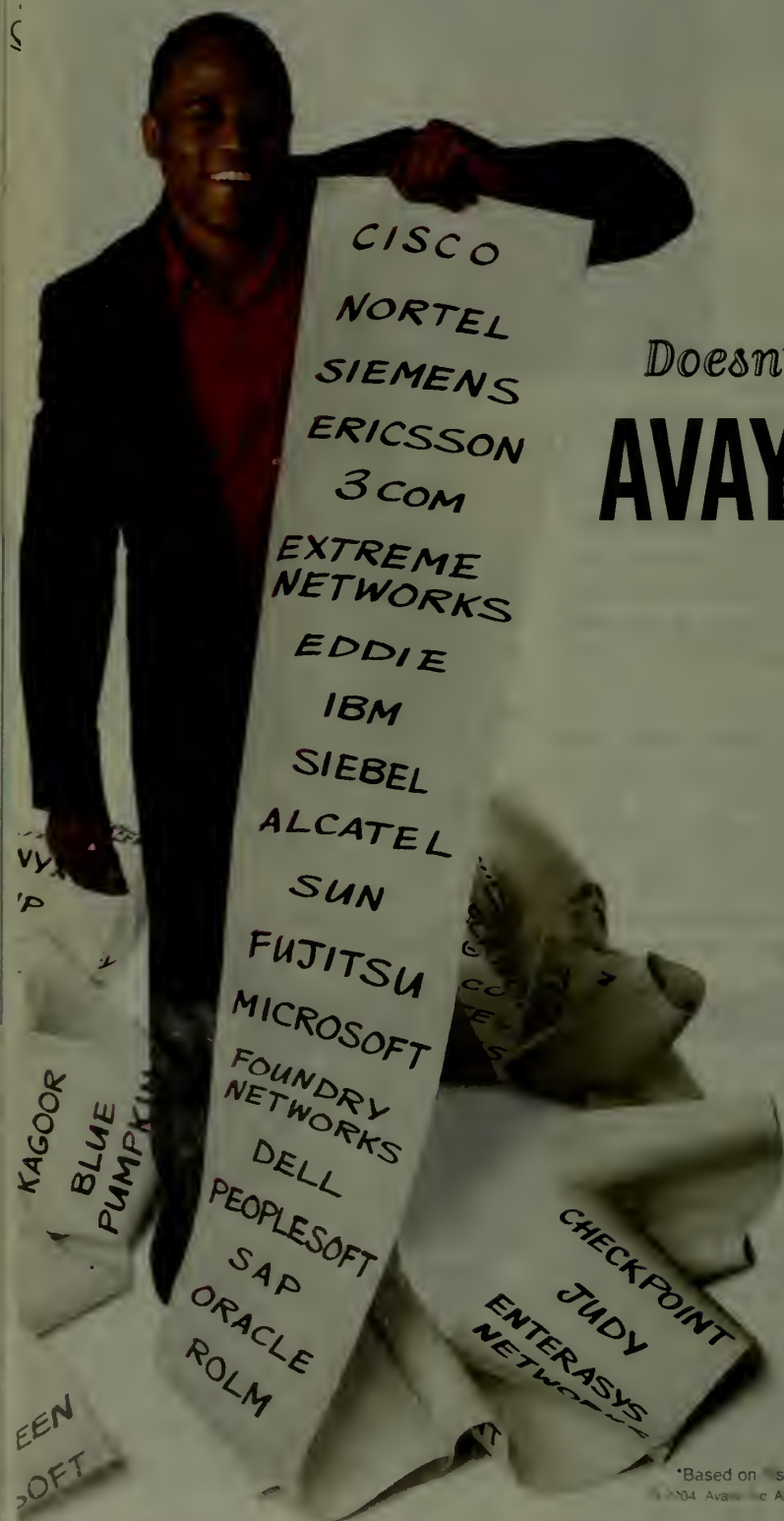
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visited—and even Frank himself—had groped and harassed them on the job. Frank paid \$2.6 million to settle the case but denies any wrongdoing. “Ridiculous,” he says of the claims.

Even with that controversy behind him, Frank is encountering some sharp elbows at the bar these days. The tequila he bought two years ago, Corazón de Agave, has yet to take off. Frank says it is about to get same kind of marketing love that he showered on Grey Goose. He gave the vodka a high \$30-a-liter price tag, made it a fixture at ritzy events, and hawked it as the world’s best-tasting vodka after it won a 1998 award. But most rivals now use similar guerrilla marketing tactics. His new products will enter crowded fields, as well, so producing another hit could be tough. Frank insists he has a secret: “I have great taste buds, and I keep them sharp—in food, wine, and women.”

‘BLOOD FROM A NICKEL’

FRANK DEVELOPED his taste for life’s finer things in college. Having grown up the son of an orchardman in Norwich, Conn., he scraped together money to attend Brown University. “It was the first time I had sheets,” he says. At home, “my mother would sew flour sacks together for sheets.” With scarce funds and mediocre marks, he dropped out before getting a degree. But by then he had befriended such high-living types as Ed Sarnoff, son of former RCA Corp. Chairman David Sarnoff. Frank “was a personable, great-looking guy who could get blood from a nickel,” says Sarnoff, who introduced Frank to Louise, the daughter of Schenley Distilleries Inc. chief Lewis Rosenstiel. Thanks to his Brown connections, Frank got a job as a troubleshooter during World War II at Pratt & Whitney Motors, then went to work for his future father-in-law. After being fired, rehired, and fired again, Frank decided in 1972 to start his own company.

These days, Frank is having as much fun spreading his wealth as he is building it. When he sold Grey Goose, he says he gave out more than \$20 million in bonuses to 180 full-time staffers, including \$250,000 to his ever-patient assistant, Donnie Duenas. He’s about to announce a \$100 million scholarship gift to Brown. As he prepares to launch a bevy of new products, Frank is also penning his autobiography. But for America’s newly minted billionaire, the next chapter has only just begun. ■

—By Diane Brady in New York



INSIDE CANDIDATE
CFO Lewent has a shot at the top job when CEO Gilmartin retires

Merck: Who Will Revive the Giant?

Earnings and new-drug disappointments have investors worried about succession

TO HEAR MERCK & CO. CHIEF Raymond V. Gilmartin tell it, the selection of the drugmaker’s next chief executive will be a model of succession planning. Gilmartin, who will retire in 2006, has said Merck has an abundance of strong internal candidates.

Few on Wall Street, however, share his confidence. As the once-dominant Merck suffers through patent expirations, earnings slips, and a dearth of new products, pressure is building on its board to find an outsider to revive the \$24 billion pharmaceutical giant. An-

alysts and executive recruiters say the board has little choice but to consider well-regarded industry veterans such as Schering-Plough CEO Fred Hassan, former Warner-Lambert chief Lodewijk J.R. de Vink, who is now at the investment firm Blackstone Group, or retired Johnson & Johnson President James T. Lenehan.

With Merck’s pipeline at a trickle, investors want an outsider

At Merck, succession is handled by a committee led by retired Honeywell Chairman Lawrence A. Bossidy. But with the company and the board unwilling to comment, it’s not clear how they plan to proceed. Investors are anxious after four products failed in development

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last year. In August, studies raised questions about the prospects for Merck's cholesterol-fighter Zocor and its painkiller Vioxx. In two years: the loss of U.S. patent protection for \$5 billion Zocor. At \$45, shares now trade at half their 2000 peak.

SKY-HIGH STAKES

While many in the industry face similar research-and-development droughts, rivals have been more aggressive about acquiring companies or licensing products to fill the gap. At the same time, Merck focused on traditional drugs instead of pushing into biotech products. For the next CEO, the stakes couldn't be higher. Says Lloyd S. Kurtz, portfolio manager at Nelson Capital Management: "Merck either reclaims its leadership in the industry, or becomes a has-been."

The best-known internal contender for the job is longtime CFO Judy C. Lewent. The 55-year-old Lewent helped forge several partnerships starting in the 1980s, including one that gave Merck a big chunk of sales from the anti-ulcer drug Prilosec, once the world's best-selling drug. In 2003, Lewent took over Merck's Asian operations. Still, she enjoys scant credibility among investors who have been disappointed repeatedly, including in 2003 when Merck failed to deliver the double-digit earnings growth it had promised.

Instead, current and former Merck execs are betting on an unknown. Bradley T. Sheares, 47, a onetime cancer researcher who joined Merck in 1987, now is co-head of its U.S. drug business. But he has little global experience and no record of steering corporate strategy. A long shot: Peter S. Kim, 46, who joined Merck in 2001. He has shaken up Merck's R&D unit, but has little business experience.

If Merck has to scramble to bring in an outsider, it will mark the second time the board has been caught unprepared. It recruited Gilmartin from medical supplier Becton-Dickinson in 1994. Possible contenders include Lenehan, 55, a proven manager of large-

scale operations at J&J, and de Vink, 59, Warner-Lambert's chief during its heyday in the late 1990s. But the most obvious candidate is Schering-Plough's Hassan, 58. Merck and Schering have a joint venture to market the cholesterol drug Vytorin. If Merck acquires Schering, it would allow Merck to gain complete control of Vytorin's potential blockbuster revenues—and pave the way for Hassan to succeed Gilmartin. With Gilmartin opposed, an acquisition seems unlikely. All three executives declined to comment.

At a minimum many investors expect the board to examine all options by conducting an external search while it considers the internal candidates. For weary Merck shareholders, a shot of fresh blood may be the perfect medicine. ■

By Amy Barrett in Philadelphia, with
Michael Arndt in Chicago



Schering-Plough's Hassan is a possibility

Merck's Leadership Riddle

The drugmaker has no obvious heir to chairman and CEO Raymond V. Gilmartin, who retires in 2006.

THE INSIDERS

JUDY C. LEWENT
Merck's longtime CFO is a first-rate financial exec. But Lewent, 55, has little operating experience and is part of the team that disappointed investors.

BRADLEY T. SHEARES
A onetime cancer researcher who co-runs the U.S. business, Sheares, 47, is a charismatic marketing executive but untested.

PETER S. KIM Kim, 46, has shaken up Merck's once-insular R&D unit. He has little business experience and is seen as a long shot.

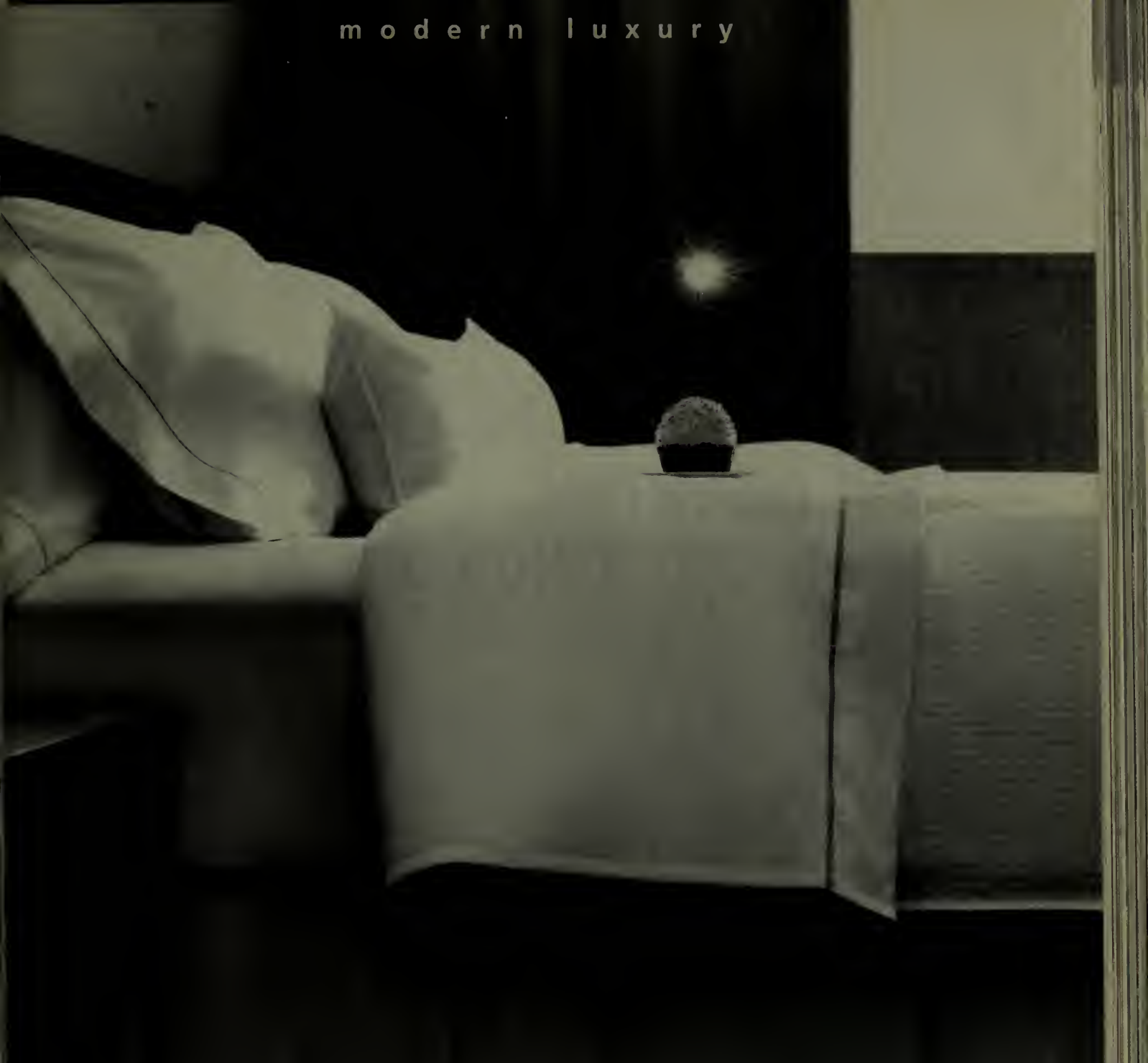
THE OUTSIDERS

FRED HASSAN The CEO of Schering-Plough, Hassan, 58, could take the helm if Merck buys Schering, as some on Wall Street advocate.

LODEWIJK J.R. DE VINK
The 59-year-old former CEO of Warner-Lambert is well regarded, despite his failed efforts to fend off Pfizer in 1999.

JAMES T. LENEHAN
The former president of Johnson & Johnson recently retired at 55 after being passed over for the top job. A highly regarded manager, he never ran a prescription drug business.

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No longer the brat of sports marketing, it has a higher level of discipline and performance

BY STANLEY HOLMES

The New NIKE



OLYMPIC GOLD
Feet wearing
Nikes cleaned
up in Athens

Nike

IN MANY WAYS, THE SLEEK, FOUR-STORY BUILDING

that houses Nike Inc.'s Innovation Kitchen is a throwback to the company's earliest days. Located on the ground floor of the Mia Hamm building on Nike's 175-acre headquarters campus in Beaverton, Ore., the Kitchen is where Nike cooked up the shoes that made it the star of the \$35 billion athletic footwear industry. In this think tank for sneakers, designers find inspiration in everything from Irish architecture to the curving lines of a Stradivarius violin. One wall displays models of every Air Jordan ever made, while low-rise cubicles are littered with sketches

ANDY LYONS/GETTY IMAGES

COVER STORY

of new shoes. The Kitchen is off limits to most visitors and even to most Nike employees. The sign on the door says, only half in jest: "Nobody gets in to see the cooks. Not nobody. Not no how."

This is where, nearly 20 years ago, Nike star designer Tinker Hatfield came up with the Air Jordan—the best-selling sports shoe of all time. Right now, Hatfield and his team are tallying the results of the Athens 2004 Olympic Games. Hatfield and his design geeks produced an array of superfast sneakers for the Games, including the sleek track spike called Monsterfly for sprinters and the Air Zoom Miler for distance runners. As befits a global company, Nike's sponsored athletes hailed from all over the world. They took home a lot of hardware from Athens, including 50 gold medals and dozens more silver and bronze. In the men's 1,500-meter run, for instance, Hicham El Guerrouj of Morocco grabbed gold, Bernard Lagat of Kenya took the silver, and Rui Silva of Portugal won the bronze. All wore the Air Zoom Miler, while U.S. sprinter Shawn Crawford won the 200-meter gold in a pair of Monsterflys. And Nike apparel had its day in the sun, too. The top four finishers in the men's 100-meter race all wore the sign of the Swoosh.

GOING ESTABLISHMENT

THE MOST TELLING EVENTS for Nike didn't take place on the track, however. The brash guerrilla marketer, famous for thumbing its nose at big-time sporting events, was showing a new restraint. Eight years ago in Atlanta, Nike ambushed basketball sponsor Champion (a brand of Sara Lee Corp.) by sneaking giant Swoosh signs into the arena. When the cameras panned the stands, TV audiences saw the Nike logo loud and clear, while Champion had nothing. Nike has even signed up to become an official U.S. Olympic sponsor in four years in Beijing, and it has toned down its anti-Establishment attitude. For good reason: These days, Nike is the Establishment when it comes to global sports marketing. With revenues exceeding \$12 billion in fiscal 2004, the company that Philip H. Knight started three decades ago by selling sneakers out of the back of a car at track meets has finally grown up.

The kind of creativity that led Bill Bowerman, the University of Oregon track coach who co-founded the company with Knight, to dream up a new kind of sneaker tread after studying the pattern on his wife's waffle iron, is still revered at Nike. When it comes to the rest of the business, however, it's a whole new ball game. Gone are the days when Nike execs, working on little more than hunches, would do just about anything and spend just about any amount in the quest for publicity and market share. Scott Bedbury, a former Nike marketing chief, recalls pitching



NIKETOWN IN NEW YORK:

Fashion vies with footwear on 57th Street

his advertising budget to Knight back in 1987. He was asking for a huge increase, from \$8 million to \$34 million and was prepared to make his case. Instead, Knight asked him the one question he hadn't prepped for: "How do we know you're asking for enough?" That year, Nike spent a jaw-dropping \$48 million. The brash innovator of sports marketing may still open the checkbook wide—as it did when it signed basketball phenom LeBron James to a \$90 million endorsement contract last year, but those grand gestures are far fewer at the new Nike.

In the past few years, the company has devoted as much energy to the mundane details of running a business—such as developing top-flight information systems, logistics, and (yawn) supply-chain management—as it does to marketing coups and cutting-edge sneaker design. More and more, Nike is searching for the right balance between its creative and its business sides, relying on a newfound financial and managerial discipline to drive growth. "Senior management now has a clear understanding of managing the



Nike Through The Years

The company that made sports marketing hip was co-founded by an accountant

1964

Phil Knight, a CPA at Price Waterhouse, and college track coach Bill Bowerman chip in \$500 each to start Blue Ribbon Sports.

1970

Bowerman, inspired by his wife's **waffle iron**, dreams up new shoe treads. The Waffle Trainer becomes the best-selling U.S. training shoe.

1971

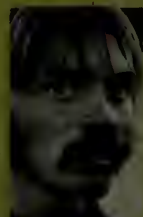
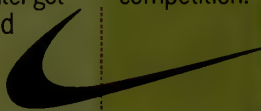
Blue Ribbon changes its name to Nike and adopts the **Swoosh**. The original logo (below) was designed by a college student for \$35. She later got an undisclosed amount of stock.

1973

Long-distance runner **Steve Prefontaine** becomes the first major track athlete to wear Nikes in competition.

1980

Nike goes public selling 2.4 million shares at \$11 apiece. After several splits, Nike stock now trades around \$7 a share.





Nike's growth strategy is to add to its portfolio of brands.

To many of the Nike faithful, those sorts of changes smacked of heresy. LeBron James is cool. Matrix organization and corporate acquisitions aren't. But cool or not, the new approach is working. In fiscal 2004, ended May 31, Nike showed just how far it had elevated its financial game. It turned in a record year, earning almost \$1 billion, 27% more than the year before, on sales that climbed 15%, to \$12.3 billion. What's more, orders worldwide were up a healthy 10.7%. In North America orders rose 10% following eight stagnant quarters.

That performance has pleased investors, who now see a company where earnings are less volatile and less fad-driven, yet still growing rapidly enough to spin off lots of cash. In the past fiscal year, Nike's free cash flow totaled \$1.2 billion, and its return on invested capital was 22%, up from only 14% four years ago. The company boosted its dividend by 43% last fall and completed a \$1 billion share repurchase. It plans to buy back \$1.5 billion more in shares over the next four years. The result: Nike stock recently traded at about 78, up 37% in the past year vs. a 9% rise in the Standard & Poor's 500-stock index. The truth is, the onetime corporate rebel is edging toward blue-chip respectability. Who'd have figured?

Nike believes its newfound discipline will enable it to meet

» To the Nike faithful, the new organization smacked of heresy

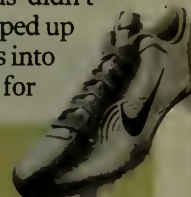
creative process and bringing it to the bottom line. That's the big difference compared to the past," says Robert Toomey, an equity analyst at RBC Dain Rauscher Inc. in Seattle.

BUSINESSLIKE—AND UNCOOL?

IN THE OLD DAYS, NIKE OPERATED pretty much on instinct. It took a guess as to how many pairs of shoes to churn out and hoped it could cram them all onto retailers' shelves. Not anymore. Nike has overhauled its computer systems to get the right number of sneakers to more places in the world more quickly. By methodically studying new markets, it has become a powerhouse overseas—and in new market segments that it once scorned, such as soccer and fashion. It has also beefed up its management team. And after stumbling with its acquisitions, Nike has learned to manage those brands—Cole Haan dress shoes, Converse retro-style sneakers, Hurley International skateboard gear, and Bauer in-line and hockey skates—more efficiently. Indeed, part of

its targets of 15% average annual profit growth and revenue growth in the high single digits. Wall Street shares that optimism. Says John J. Shanley, an analyst at Susquehanna Financial Group, an institutional broker in Bala Cynwyd, Pa.: "Nike is probably in the best financial position it has been in in a decade." In fact, some analysts believe Nike is poised to become a \$20 billion company by the end of the decade.

That would have seemed laughable just a few years ago—sales started falling after hitting the \$9.6 billion mark in 1998. Even before Nike's superstar endorser and basketball great Michael Jordan retired from the game in 2003, Nike's creative juices seemed to have run dry. Air Jordans at \$200 were collecting dust on store shelves as buyers seeking a different look began switching to Skechers, K-Swiss, and New Balance shoes. Nike wrestled with accusations that it exploited Asian factory workers. Ho-hum new sneakers and troubled acquisitions didn't help. Nike, eager to regain its old momentum, bumped up production—only to end up pushing more sneakers into the market than the customers wanted to buy. As for



1985

The Air Jordan, best-selling athletic shoe of all time, makes its debut.



1987

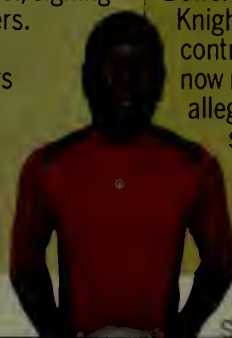
Nike scores its first memorable ad campaign. *Revolution*, built around the Beatles song, disgusts some rock 'n' roll purists—but it puts Nike on the map.

1992

When picking up their Olympic medals, Nike-sponsored players like Magic Johnson use U.S. flags to hide Reebok jackets. The first Niketown opens.

1994

Nike begins its move into soccer, signing top players. Current endorsers include soccer star Freddy Adu, 15.



1999

Co-founder Bowerman dies, and Knight reasserts control at Nike, now reeling from allegations of sweatshop conditions overseas.

2003

For the first time, more than half of Nike's sales come from outside the U.S. New products like the Mercurial Vapor have helped lift Nike past Adidas as the No. 1 European soccer shoe.

COVER STORY

CRUNCH TIME

Nike gets the better of a BMW at a Bangkok promotion



financial discipline? Well, just consider this: From 1997 to 1999, Nike didn't even have a chief financial officer. "We had a bit of a burning platform," says Donald W. Blair, the executive whom Knight recruited from PepsiCo Inc. to fill the position.

It was during those tough times that Phil Knight, who had disengaged from Nike in order to travel and pursue other interests, came back to the company. The year was 1999. Co-founder Bowerman had died, and Nike was floundering. Knight, now 66, needed to set things straight. Standing before thousands of employees at a company meeting, he admitted that the managers who were running the place had failed. And he went on to blame himself. "He said he wasn't as engaged as he should be, and he said there were things he could do better," recalls Steve Miller, Nike's former global sports marketing director, who was there. "I was personally stunned he would be so open about his failings." Knight, whose son died in a scuba diving accident earlier this summer, declined to speak to *BusinessWeek*.

Knight has been hailed as a visionary for his company's breakthrough design, technology, and marketing prowess. In the 1980s and '90s, Knight forever changed the rules of sports marketing with Nike's huge endorsement contracts and in-your-face advertising. Mixing marketing and pop music is commonplace now. But Nike created a small furor in 1987 when it used the Beatles' *Revolution* in ads to sell cross-training sneakers.

Still, when his iconoclastic company faltered, Knight looked

beyond the technology and marketing antics that had served it well in the past. Upon his return to the company five years ago, his first order of business was to put together a new executive team. Knight drew on some Nike veterans, executives who carry the heritage and culture of Nike's early years. But he also recruited some key players from far outside Nike and its industry. CFO Blair, who came aboard in 1999, was lured from Pepsi, while Mindy F. Grossman was plucked from Polo Ralph Lauren Corp. the next year with the mission of redefining Nike's \$3.5 billion global apparel business. The day-to-day boss, Chief Operating Officer Thomas E. Clarke, now runs Nike's new business ventures division.

Knight made his boldest management move in 2001, when he named two longtime Nike insiders, creative brand and design wonk Mark G. Parker and operations maven Charles D. Denson, as co-presidents. With Grossman and Blair providing an outsider's perspective and with Parker and Denson steeped in the company's culture, Knight hoped to achieve a balance between the old and the new, the creative and the financially responsible. The unusual co-president structure was hardly Business 101, and many observers figured the new team wouldn't last. Few believed co-presidents could survive the inevitable political maneuvering and clash of egos.

SUCCESSION SWEEPSTAKES?

NO MATTER WHAT ELSE Knight intended, it also looked very much as if he had set up a horse race among those most likely to succeed him. Knight, who owns 80% of Nike's voting stock, and about 36% of the common shares, has never said when or even if he will retire or what will happen to his voting stock on his death. Speculating on his eventual departure has been the topic of water-cooler conversations for nearly a decade. The succession issue remains the single biggest question at the company, although the new management structure has gone a long way toward assuring investors that the bench is deep.

Possibly because there was little time for politicking or backstabbing, given Nike's plight, Parker, Denson, and the rest have

All Grown Up

No longer does Nike depend just on high-performance shoes.

FINANCIAL DISCIPLINE

For a time in the late 1990s, Nike didn't even have a chief financial officer. Expenses sometimes spiraled out of control. The arrival of Don Blair from PepsiCo in 1999, who became CFO, and the creation of a new management team brought order and discipline.

IMPROVED OPERATIONS

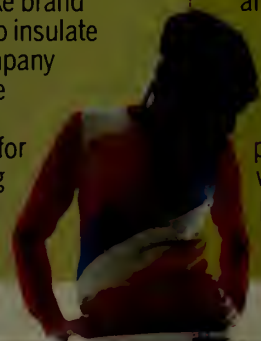
For years Nike's antiquated supply-chain system struggled to move goods efficiently from factory to retailer. Nike spent \$500 million modernizing its technology. The result: Nike gets products to customers faster and cheaper.

NEW VENTURES

Nike is committed to owning brands that complement its core Nike brand and help insulate the company from the volatile market for sporting goods.

EXPANDING BRAND NIKE

The Beaverton (Ore.) outfit is not just a sneaker company anymore. These days, Nike is big in sports fashion and has become a powerful player in the world's most popular sport, soccer.



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mostly steered clear of those pitfalls and focused on shoring up Nike's weaknesses. "There are aspects of this culture that are incredibly powerful and strong," says Parker, citing design and marketing. "But we needed to get after the basic pieces of the business: operating principles, financial management, supply-chain renovation, and inventory management."

In the old days at Nike, the culture encouraged local managers to spend big and to go flat-out for market share instead of profitability. In Paris, for instance, the company spent lavishly for a soccer park at the 1998 World Cup to promote itself. Analysts estimate, conservatively, that it was more than \$10 million over budget. The cost, which Nike never disclosed, caused Wall Street to start asking whether anyone was in charge.

So Parker and Denson engineered a matrix structure that breaks down managerial responsibility both by region and product. Because the company pumps out 120,000 products every year in four different launch cycles, local managers always had plenty of choice—but also plenty of ways to screw up. Under the matrix, Nike headquarters establishes which products to push and how to do it, but regional managers are allowed some leeway to modify those edicts. The matrix won't guarantee that another fiasco like the Paris soccer park cannot occur, but it makes it a lot less likely.

FILLING THE ORDERS

NIKE ALSO OVERHAULED ITS supply-chain system, which often left retailers either desperately awaiting delivery of hot shoes or struggling to get rid of the duds. The old jerry-built compilation strung together 27 different computer systems worldwide, most of which couldn't talk with the others. Under Denson's direction, Nike has spent \$500 million to build a new system. Almost complete, it is already contributing to quicker design and manufacturing times, and fatter gross margins—42.9% last year, up from 39.9% five years ago. Nike says that the percentage of shoes it makes without a firm order from a retailer has fallen from 30% to 3%, while the lead time for getting new sneaker styles to market has been cut to six months from nine.

Meanwhile, Nike has started paying serious attention to its handful of acquisitions, once treated as more of an afterthought. After buying up Cole Haan almost 15 years ago, Nike struggled to add any real value at the dress-shoe outfit. But lately, Nike managers have figured out that by giving their acquired brands some independence, rather

than forcing Nike's testosterone-laced corporate culture on them, they can achieve better results. "We've learned to let those brands pull resources and expertise out of the mother ship as opposed to pushing the mother ship onto the brands," Blair says. Nike doesn't break out results for each sub-brand, but the group's sales grew 51%, to \$1.4 billion last year. With nearly a quarter of the sales growth, Converse was the star.

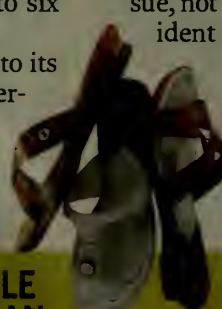
That still-modest portfolio of different brands helps to lessen the company's dependence on hit shoes and could help Nike turn in a more consistent performance. That's why Nike is eager to snap up complementary brands as they become available. In mid-August it paid \$43 million for Official Starter Properties

» Nike's response to '90s sweatshop charges: Anger and panic

licensors of sneakers and athletic apparel whose brands include the budget-level Shax label. "What we're trying to do is move toward more of a consumer, noncyclical model," says Blair. "The key is trying to find the right balance of discipline, innovation, creativity, and structure."

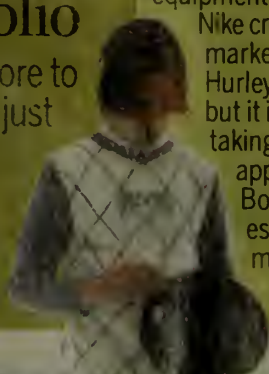
Nike has also had to grapple with the touchy topic of sweatshop labor at the 900-odd independent overseas factories that make its clothes and sneakers. When Nike was getting pummeled on the subject in the 1990s, it typically had only two responses: anger and panic. Executives would issue denials, lash out at critics, and then rush someone to the offending supplier to put out the fire. But since 2002, Nike has built an elaborate program to deal with charges of labor exploitation. It allows random factory inspections by the Fair Labor Assn., a monitoring outfit it founded with human rights groups and other big companies, such as Reebok International Ltd. and Liz Claiborne Inc., that use overseas contractors. Nike also has an in-house staff of 97 which has inspected 600 factories in the past two years, grading them on labor standards. "You haven't heard about us recently because we have had our head down doing it the hard way. Now we have a system to deal with the labor issue, not a crisis mentality," says Maria S. Eitel, Nike vice-president for corporate responsibility.

It's overseas, in fact, where most of Nike's sales now come from. Last year, for the first time, international sales exceeded U.S. sales—still the company's single largest market. Under Grossman, Nike is making sports fashion a core business, something unthinkable until recently inside



Nike's Company Portfolio

There's more to Nike than just the iconic sneaker brand



HURLEY INTERNATIONAL

This skateboard-equipment maker helps Nike crack the youth market. Nike helps Hurley overseas, but it is otherwise taking a hands-off approach. Bought for an estimated \$95 million in 2002.

COLE HAAN

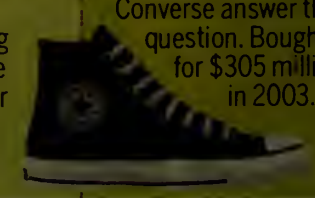
Nike's first-ever acquisition, this maker of dress and casual shoes has only recently got on its feet, mainly by incorporating athletic-shoe technology while becoming more fashion-conscious. Bought for \$80 million in 1988.

BAUER

Makes ice hockey skates and related sports gear. Bauer also manufactures inline skates. The consensus on Wall Street: Nike overpaid by buying at the height of the fad. Purchased for \$409 million in 1995.

CONVERSE

Its retro-style sneakers have made it the most successful sub-brand. Nike is concerned with how to keep the brand fresh, but is letting Converse answer that question. Bought for \$305 million in 2003.



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INSIDERS
Co-Presidents
Parker and
Denson

Nike's male-dominated culture. Thanks to stylish athletic wear—think tennis star Serena Williams at the U.S. Open—Nike's worldwide apparel sales climbed 30% in three years, to \$3.5 billion in fiscal 2004.

Of course, Nike still faces challenges. After several years of red-hot growth, European sales of higher-priced shoes have started to slide. In the U.S., retro-sneaker makers like K-Swiss, Diesel, and Puma are filling a rising demand. And adidas-Salomon has redoubled efforts to attack the North America basketball market, where Nike has a 60% share. Taking a leaf from Nike's book, Adidas just signed three NBA all-stars: Tracy McGrady, Tim Duncan, and Kevin Garnett, each of whom will have his own sneaker. On the technology front, Adidas has unveiled the Adidas 1, a \$250 shoe slated for December that has a computer chip that automatically adjusts the fit as the wearer runs.

Nike aims to keep pace in the techno-battle with Nike Free,

a shoe still being tested, that makes runners feel as if they were barefoot. It's inspired by the barefoot runners of Kenya, who have proved that shoeless training builds strength and improves performance. Meanwhile the company continues to refine its Shox technology—a special cushioning system first developed for runners, which is now becoming a top seller in categories from running to basketball to cross training. The shoes, which sell for up to \$135 a pair, helped put to rest the idea that high-priced sneakers no longer sell well in the U.S.

SWIFTEST KICK

NIKE HAS ALSO SHOWN it can grow by expanding into new markets. When the U.S. hosted the World Cup in 1994, Nike's global soccer sales were \$45 million. But a team of executives persuaded Knight that soccer was the company's future. Today, soccer sales are nearly \$1 billion, or 25% of the global market. This year, for the first time, Nike's share of the soccer shoe market in Europe, 35%, exceeded Adidas, at 31%. Nike has achieved that fast growth in part by using the same outsize marketing tactics that made it big in the U.S. It paid the prestigious Manchester United club an unprecedented \$450 million over 14 years to run its merchandising and uniform operation.

Just before this summer's European soccer championships, Nike launched its Total 90 III, a sleek shoe that draws inspiration from cars used in the Le Mans 24-hour road race. Nike realized that millions of kids around the globe play casual pickup soccer games in the street and developed the shoe especially for them. That insight does not impress soccer purists. "Nike is selling a lot of the Total 90 street shoes and is including them in the soccer category," huffs Adidas CEO Herbert Hainer. "They are trying to turn the business model into a lifestyle." He's right, of course. Just as Nike made basketball shoes into an off-the-court fashion statement, its Total 90s have become fashion accessories for folks who may never get closer to a soccer pitch than the stands.

What's the lesson? Let other companies worry about the traditional boundaries between sport and fashion. Nike has built its empire by transforming the technology and design of its high performance sports gear into high fashion, vastly expanding its pool of potential customers. If competitors want to get hung up on what exactly Nike's selling, that's O.K. with the folks in Beaverton. It's all Nike to them. ■

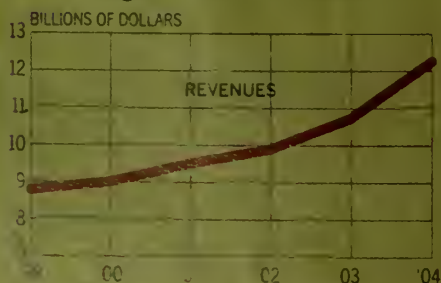
—With Aaron Bernstein in Washington

BusinessWeek online

For a Q&A with Nike Chief Financial Officer Donald Blair, and more on Nike's labor issues, go to www.businessweek.com/magazine/extra.htm

Nike Scores

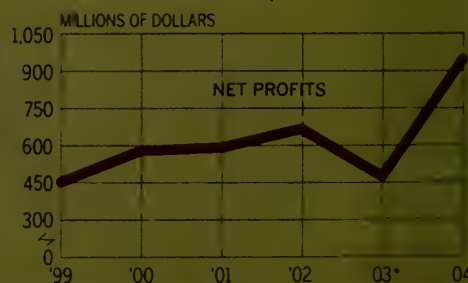
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NOTE: FOR FISCAL YEARS ENDING MAY 31 *AFTER WRITE-OFF OF INTANGIBLES AND GOODWILL OF \$266 MILLION



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Novell.



How Nielsen Stood Up to Murdoch

Fox played the race card to upend a new TV ratings system. It didn't work

SUSAN D. WHITING KNEW she was in for a long, hot summer as early as Mar. 30. That was the day Rupert Murdoch, media mogul supreme, interrupted a discussion about interactive advertising to lambaste her in front of many of TV's most powerful executives. Whiting, president and CEO of Nielsen Media Research, was stunned but maintained her composure. "I'd never met Mr. Murdoch before, but I felt I had to respond," she recalls. "So I did, and

then I asked if we couldn't go back to the subject we had all come to discuss."

What incensed Murdoch, the chairman of News Corp., is a Nielsen plan to change the way it tracks TV viewing in the 10 largest U.S. markets. Beginning late last year, Nielsen began phasing out the written diaries it has used since the 1950s in favor of an electronic device called the people meter that measures audiences

UNFLAPPABLE
CEO Whiting got a baptism by fire

much more reliably. In people meter test runs in New York and Los Angeles, many high-profile programs on News Corp.'s Fox network took ratings hits, including several geared to blacks and Hispanics. In an attempt to force a delay in Nielsen's conversion to people meters, News Corp. funded a grassroots political campaign accusing the ratings company of disenfranchising minority viewers.

Whiting, 48, has had to defend herself and her company in dozens of public forums, including a U.S. Senate hearing and stormy city council meetings in New York and Los Angeles. At least 40 members of Congress criticized Nielsen. Whiting, who moved up to CEO in 2002 after 24 years at the company, also endured a tongue-lashing by the Reverend Al Sharpton, who stormed into her office while a contingent of reporters waited outside.

HIGH-HANDED

NIELSEN, OWNED BY Dutch media conglomerate VNU, is no stranger to controversy. Complaining about the inflexibility of Nielsen, its arrogance, and, above all, its high prices is a long-standing tradition among the TV programmers and ad agencies that have never really had a practical alternative to buying its ratings data. "The industry has a love-hate relationship with Nielsen," says David Verklin, CEO of Carat North America, a large media-buying agency. "Actually, it's hate-love, and there's not a whole lot of love in it."

This current contretemps, however, is something new for Nielsen Media—in the virulence and breadth of the attacks directed against it. News Corp.'s attack transformed an intra-industry dispute over research methods into a racial and ethnic cause célèbre. This strategy was cleverly conceived to exploit Nielsen's unpopularity and inexperience in the dark arts of political string-pulling and public relations spinning. "They were totally caught off guard when Rupert came out, guns blazing," concedes Angela Mariana Freyre, a partner at Coudert Brothers LLP, outside counsel to Nielsen.

The people meter is a long-established technology widely used around the world to measure TV audiences. Since the 1970s, Nielsen has used a so-called set meter to track the viewing of its sample

Ad agencies have "a love-hate relationship with Nielsen"

households. It tells Nielsen what is being watched—but not who is watching. Four times a year, Nielsen collects the finer demographic data prized by advertisers by asking all viewers to fill out a diary detailing their TV watching for a week. It's no secret that many families keep their diaries haphazardly. The people meter provides much more reliable data by automatically recording every channel change and by adding a set-top console that all viewers identify themselves by the push of a button or two.

In 1987, Nielsen introduced people meters into its national sample, which consists of 5,000 households across the country. The new meters proved that people of all ages and races were far more diverse in their viewing habits than the written diaries had shown. Ratings points—and ad dollars—migrated en masse from high-rated shows to low-rated ones and from broadcast to cable networks. Many broadcasters complained bitterly at first, but the national people meter ratings now set the standard for TV measurement in the U.S.

It was not until VNU acquired Nielsen Media for a hefty \$2.5 billion in 2001 that the company and newly appointed CEO Whiting announced ambitious plans to also begin using people meters to measure local audiences in the top 10 U.S. cities, beginning with Boston in 2002. The advent of the local people meter was a particularly ominous development for News Corp., which is much more heavily weighted to broadcast and lighter on cable than are the corporate parents of CBS, NBC, and ABC.

Nonetheless, in October, 2003, Fox Television Station Group signed a comprehensive new service contract with Nielsen covering all 35 Fox stations in the U.S. Under this agreement, Fox agreed to buy people meter data in all 9 of the top 10 markets where it owned a station. By February, though, News Corp. had become so alarmed by the people-meter test-run data from New York that it demanded that Nielsen postpone the scheduled start of commercial service on Apr. 8. Whiting refused. A few weeks later, News Corp. issued a statement by Lachlan K. Murdoch, Fox's chairman (and Rupert's son), that framed its objections in a racial context: "People meters could undercount viewership by as much as 25%, especially when quantifying viewership among minority and young viewers."

About the same time, a newly formed group called the Don't Count Us Out coalition began going after Nielsen. News Corp. has acknowledged that it supported Don't

Count Us Out "financially, organizationally, and morally" but denies Nielsen's accusations that the coalition is a front for Fox. "This is a group who saw that [Nielsen's] data wasn't accurate and rose up against it on their own," says News Corp. spokesman Gary Ginsberg.

With the help of a bevy of high-powered media consultants who had held senior positions in the Clinton White House—including press secretary Joe Lockhart—Don't Count Us Out rapidly enlisted dozens of Democratic lawmakers and scores of minority advocacy groups. The group also took aim at the masses, hiring canvassers to take its anti-Nielsen message door to door and unleashing a barrage of print and TV advertising. So many complaints poured into Nielsen's New York office that its phone and e-mail systems crashed.

Nielsen was caught off guard in part because it thought it had bent over backwards to ensure that blacks and Hispanics were fully represented. Black households make up 21.2% of the new New York people meter sample, compared with 17.3% of the city's population as measured by the 2000 census; the

Most critics eventually backed away from all the fracas

comparable numbers for Latinos are 16.8% and 16.1%. Whiting says that Nielsen deliberately "oversampled" minority households because of the possibility that blacks and Latinos were undercounted in the census. "The official benchmarks may be too low," she says.

Don't Count Us Out made much of the fact that many of the shows with the steepest ratings drops in New York were geared to people of color. For example, *The Parkers*, *Girlfriends*, *Eve*, and *Half & Half* suffered potentially fatal declines of 27% to 62%. However, the coalition failed to mention the jump in viewership for other minority-themed programs on cable. In March, black viewership of Black Entertainment Television soared 180%. Among Latino viewers, Telefutura's ratings jumped 83%.

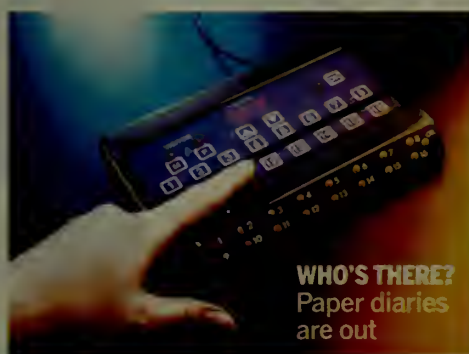
JUST NOT HERE

NIELSEN WASN'T COUNTING minority viewers out: It was counting them elsewhere. Rating points were shifting en masse from broadcast to cable, reflecting what had occurred in Boston and nationally. As measured by the people meter, blacks in New York spent 54.2% of their viewing time on cable, compared with the 39.2% reported by the diaries. For Latinos, the shift was less dramatic but still significant at 43.8% to 34.6%.

Even as politicians rushed to enlist in Don't Count Us Out, executives of other media companies kept a wary distance. They not only saw no evidence of racial bias in Nielsen's people meter numbers, but generally disapproved of News Corp.'s rabble-rousing tactics. "Buying full-page ads in *The New York Times* is not an effective way of bringing about change in the science of television measurement," says Gayle Metzger, a longtime Nielsen critic who tried to start a competing company in the 1990s.

Whiting, a Wisconsin native, is not the combative sort, but her graciousness masks a steely resolve. Combining what one friend calls "an almost nerdy, Midwestern frankness" with a deep knowledge of the science of television ratings, Whiting was fiercely imperturbable as she ventured out to meet with people meter opponents located around the country. "I've seen her get mad, but the only way you can tell is that her face turns red," says Jack Loftus, Nielsen's communications chief. "I've never seen her lose her cool."

It was a testament to the CEO's effec-



The Meter Is Running

Nielsen Media's new people meter records a big drop in the number of blacks watching network TV, but an equally large rise in its share of cable:

NETWORK SHARE*	CABLE SHARE*
-15%	+15%

*Percentage point change. New York audience in March 2004.
Data: Nielsen Media Research

The Corporation Management

tiveness that Senator Hillary Clinton, the NAACP's Kwiese Mfume, and other high-profile supporters of Don't Count Us Out quietly backed away from the coalition. On Sept. 7, the Reverend Jesse Jackson stepped forward to endorse Nielsen in an open letter addressed to members of the Rainbow/PUSH Coalition. "People meter measurements prove that audiences of color—like other viewers—are shifting their allegiances from big broadcast channels like News Corp.'s Fox Television to smaller channels and networks," said Jackson.

At the same time, though, Whiting antagonized such major clients as CBS, Tribune Broadcasting, and Univision by insisting on going live with the people meter service in New York without first obtaining the blessing of the Media Ratings Council,

Fighting Back

Here's how Susan Whiting met News Corp.'s broadside

MADE her case everywhere, from Congress to city councils to community groups

WON OVER influential power brokers including Hillary Clinton and Jesse Jackson

BUILT support among clients by being more responsive to their concerns

an independent industry group. MRC's auditors discovered a host of technical shortcomings of the same sort that had bedeviled previous people meter conversions and which TV executives attribute to

Nielsen's overeagerness to begin charging for people meter data and preserve its 25% profit margins. Nielsen has won conditional MRC accreditation in Los Angeles and is working to fix sampling flaws in New York and Chicago.

By all appearances, Nielsen now has the whip hand in its struggle with News Corp. Whiting's public relations offensive has blunted the threat of federal oversight of the ratings business, and the company scored a crucial legal victory when a state judge in California declined to halt Nielsen's people meter rollout in Los Angeles. As for News Corp., it continues to do business with Nielsen—incontrovertible evidence that the company's lucrative monopoly is intact. ■

—By Anthony Bianco in New York, with Ronald Grover in Los Angeles

Strategies

The Wal-Mart of Meat

Tyson Foods produces one of every four pounds of U.S. beef, chicken, and pork. Is that a problem?



CEO TYSON He has won kudos for management savvy

IT'S NOT EASY following in the footsteps of a legend. Just ask John H. Tyson, the 51-year-old CEO of Tyson Foods Inc. For years he toiled in the long shadow of his father, Don Tyson, a colorful, free-wheeling Arkansas good ol' boy who transformed not only his father's company but the entire poultry industry. With rapid-fire acquisitions and such product innovations as McDonald's Chicken McNuggets, he made Tyson the king of the coop.

When John took the reins

In its code:
"We strive to be a faith-friendly company"

in April, 2000—after successfully battling years of drug and alcohol abuse—he was widely considered a lightweight whose only claim to the top job was his name. After he moved to put his stamp on the company with the \$4.6 billion acquisition of beef and pork giant IBP Inc. in 2001, investors fretted about the outsized debt and the volatile beef business Tyson was swallowing as it tripled in size.

Now, after a roller-coaster year, "Johnny," as he likes to be called, is winning respect for navigating his company through turbulent

times. With the relatively smooth integration of IBP, John Tyson has won the confidence of many investors. But his grand vision of Tyson as a one-stop shop for beef, pork, and chicken has yet to deliver juicy returns. Three years after a federal judge forced Tyson to complete the IBP marriage, beating back an attempt by Don Tyson to kill the deal, Tyson hasn't significantly boosted margins or market share. Says Gary Stibel of New England Consulting Group: "The strategy appears sound. The question now is, can they execute?"

Critics see a bigger question: What price will the new Tyson exact from meat workers, ranchers, and consumers? Tyson

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Health
Dental
Pharmacy
Disability
Long-Term Care
Life

The Corporation Strategies

is now a kind of Wal-Mart of meat, seeking to control every step of production from farm to supermarket. It produces nearly one out of every four pounds of beef, chicken, and pork consumed in the U.S. The company began consolidating the poultry business back in the 1960s. Today, Tyson has about 60% more chicken-processing capacity than its next-largest rival, Pilgrim's Pride Corp., and it enjoys a level of control that any manufacturer would envy: Contract farmers raise the chickens, but those birds are owned by Tyson. Tyson provides the chicken food and the medicine, specifies how the houses should be built, and controls the price farmers ultimately are paid.

INCREASING CONTROL

WHILE IT WAS BUYING up competitors, Tyson figured out ways to add more value to the chicken—by slicing, dicing, marinating, breeding, and pre-cooking it. Now the company wants to extend that marketing and logistics savvy to beef and pork. The goal is to sell meat and poultry products under the Tyson brand, delivered on a single truck, with a single invoice. Tyson says it's not aiming for the same kind of vertical integration in beef that it has in chicken. But marketing agreements with ranchers that cover 50% or more of its cattle supplies give it increasing control over that end of the business.

The bottom line, some contend, is a strategy that squeezes workers on one side and farmers on the other—with most of the gains going to Tyson, not the consumer. The four largest beef-packing outfits now process about 85% of beef, up from 20% in the late '70s, says C. Robert Taylor, an agriculture professor at Auburn University who has testified for cattle ranchers who are suing Tyson. "The mergers and acquisitions [in the meat industry] are more about economic power than economic efficiency," Taylor says. Tyson declined to make its top executives available for interviews, but a spokesman says, "We believe our efforts benefit the consumer."

As big as Tyson gets, though, it still has to contend with the vagaries of the farm business. Analysts give the new team high marks for managing through a

storm of bad luck, which has included everything from a Russian ban on U.S. chicken to soaring grain prices to the closing of the Japanese market amid mad-cow fears. "Almost once a quarter, something would shock the system—and it wasn't a positive shock," says analyst G. Leonard Teitelbaum of Merrill Lynch & Co. Just how quickly the company's fortunes can change was highlighted on Aug. 30, when Tyson slashed its fourth-quarter earnings outlook thanks to grain-hedging losses and weakening demand for beef and chicken. Its stock fell 8% on the news, to \$16.26 a share, as disappointed analysts scrambled to lower earnings forecasts for next year, too. Now some expect profits even to decline in 2005.

Described by some as a shy but volatile



Winging It

Three years after its merger with beef giant IBP, Tyson Foods still faces a number of challenges:

PERFORMANCE Tyson has gained little market share among retailers as a one-stop meat supplier. It slashed a fourth-quarter earnings forecast because of grain-hedging losses and consumer resistance to high meat prices. Tyson is making progress consolidating operations: Since the merger, 19 plants have been sold or shut, and debt has been cut by \$1.6 billion.

GOVERNANCE The company faces possible SEC civil action—and renewed scrutiny of its board—for allegedly failing to properly disclose \$1.7 million in perks given to retired CEO Don Tyson.

WORK FORCE Tyson could face more labor unrest and higher turnover thanks to a tougher stance on wages and benefits at some former IBP plants. Meanwhile, a lawsuit by ex-employees alleges that Tyson used illegal workers to depress wages.

Critics say Tyson squeezes workers and farmers

man, John Tyson is trying to leave his mark on the company's close-knit culture. Outsiders applaud him for putting strong executives, particularly President Richard L. Bond, in key positions. Bond, a hard-nosed cost-cutter, was formerly president of IBP. "It's really gone from entrepreneurial, cowboy, Wild West management to professional management," says food industry consultant Burt P. Flickinger III of Strategic Resource Group. Tyson also has moved to placate shareholders by adding more independent directors to the family-controlled company's board.

In a move viewed warily by some insiders, John Tyson's own religious bent is now reflected in changes made to the corporate code of conduct. Among the core values Tyson Foods now lists: "We strive to be a faith-friendly company," and "We strive to honor God and be respectful of each other, our customers and other stakeholders." Tyson has also hired 87 chaplains covering 58 plants to help employees cope with family problems, stress, and other issues. A spokesman says John is not trying to impose his faith on the company, and "we make every attempt to be inclusive of all our team members regardless of their religious persuasion."

Still, some fear the code could alienate employees. It could also make Tyson, with its scandal-tarred past, an easy target for charges of hypocrisy. Indeed, Tyson announced on Aug. 16 that the staff of the Securities & Exchange Commission intended to recommend that the agency bring a civil enforcement action against Tyson and is considering a monetary penalty. The SEC has been investigating \$1.7 million worth of perks granted to Don Tyson, who is still a director, from fiscal 1997 through 2003. He voluntarily paid \$1.5 million back to the company after a review by independent board members. "These are indications that the company still has work to do, and perhaps the monitoring bodies such as the SEC will call the company to greater accountability," says Vidette Bullock-Mixon, director for corporate relations and social concerns at the General Board of Pension & Health Benefits of the United Methodist Church. As a shareholder, the board has called on the company to eliminate the dual-class stock structure that gives the Tyson family 80% voting control.

That family stranglehold has been blamed for past lapses. In 1997, the com



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**Patriarch
Don Tyson
had to
return
\$1.5 million
in perks**

pany pleaded guilty to one felony count of illegally giving U.S. Agriculture Secretary Mike Espy gifts and favors, including trips and football tickets. In the wake of the scandal, Tyson was forced to initiate a wide-reaching ethics program. John D. Copeland, the former officer who ran the program, says his role as an independent watchdog created conflicts with John Tyson. "He told me I was too strong-willed and independent," says Copeland, now a business professor at John Brown University. "I thought that was appropriate for an ethics officer."

Investors this year have mostly looked past ethical concerns and focused on strong results as Tyson rode the low-carb-diet wave. The company says it will have slashed its debt-to-capital ratio to 43% in the fiscal year ending in September, down from 58% after the IBP merger. Even with the recent hit, Tyson's stock is up 25% so far this year, vs. 0.4% for the Standard & Poor's 500-stock index. But now that meat prices are easing, growth figures to be much tougher. Analyst Jonathan P. Feeney of Wachovia Securities says earnings in this fiscal year, excluding plant-closing costs and other onetime items, will be up 65%, to \$470 million, with sales rising 4.5%, to \$25.7 billion. But he expects 2005 profits to fall 3%.

IN THE SPOTLIGHT

THAT'S WHY TYSON IS trying so hard to move beyond traditional cuts of meat to higher-margin foods that do some of the work for the cook, as it has done with chicken. Wachovia's Feeney believes that over the next decade, by moving up the value chain, Tyson could boost operating margins to 7% from an expected 4% this year. That would be impressive considering that margins will erode for most food companies over the next 5 or 10 years, he says. But some see little sign yet that Tyson has extended its innovations in chicken to beef and pork. One big restaurant buyer says he has just begun to hear Tyson reps talk about beef and pork products, and they still lack knowledge about plant and research capabilities.

Tyson's efforts to brand beef and pork also face stiff resistance from grocers, who prefer to push their own private-la-

bel or unbranded goods. Tyson's new "value-added" products, such as deli meats and microwaveable roasts, are "me-too" items, complains one grocery wholesale-procurement executive. A Tyson spokesman says the company is focused on increasing its share of sales coming from those products from 35% to 50% in the next three to five years. It is "making progress," he says.

Meanwhile, Tyson's growing clout has put it in the spotlight as never before. Tyson has been involved in a variety of controversies, from illegal immigration to price manipulation. Last year Tyson beat federal charges that it had conspired with smugglers to bring illegal workers to its plants. But it still faces an unusual civil case by ex-employees charging that the company hired illegal workers to drive down wages. The company denies the charges. And with the IBP deal, Tyson inherited a suit that charged it with illegally manipulating cattle prices through marketing agreements that lock in portions of its supply—a widespread industry practice. A jury sided with the ranchers and determined that Tyson owed \$1.28 billion in damages. But the judge threw out the verdict and recently ordered the plaintiffs to pay Tyson more than \$70,000 in expenses.

While many industry experts expect Tyson to prevail, the cattle ranchers aren't giving up easily. Oral arguments on their appeal are scheduled for January. Tyson says the marketing pacts give it and other packers a steady supply of quality cattle while cutting risks for ranchers. The plaintiffs say the alliances pushed by Tyson and other packers will kill the independent rancher without improving quality of supplies. "It's a significant power shift," says Michael C. Stumo, a lawyer for the plaintiffs. If Tyson wins, he says, meat companies will have near-total control of the beef business, while ranchers are left with "the risk and the manure."

The company's latest advertising campaign sports the tagline "powered by Tyson." But it's the kind of power that Tyson doesn't like to talk about that ensures growing scrutiny as it pushes more protein in more places around the world. ■

—By Wendy Zellner in Dallas

I thought insomnia was keeping me up all night. Until finally, one morning I realized it was the bank. I kept worrying about our ratings systems and whether they really worked or not. That's why I got in touch with Standard & Poor's **RISK SOLUTIONS**. When we compared our ratings, were we always in lockstep? No, but the good news is, I have a real benchmark. So, now I have no problem falling asleep. But I miss half of prime time.

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Big Program On Campus

Over half of U.S. colleges have embraced Blackboard's classroom-boosting features

IT'S SEPT. 1, THE FIRST DAY OF classes at Georgetown University, and roommates Charnella Palaby and Lauren Caselli are checking out their Blackboards. But that doesn't mean they're looking at chalk-smudged diagrams at the front of the classroom. Instead, the 19-year-olds are using software from Blackboard Inc. that's changing the very notion of going to school. Palaby and Caselli can fire up their laptops and go online to get assignments, take tests, listen to Spanish-language drills, even join in a discussion of Dostoyevsky's *Crime and Punishment*. Thanks to Blackboard, they can pursue classroom activities anytime, anyplace. "If I misplace my syllabus, it's always there on Blackboard," says Palaby, a government major from San Francisco.

What these two sophomores take for granted is a technology that earlier generations of collegians may not even know exists. Matthew S. Pittinsky and Michael



L. Chasen founded Washington-based Blackboard in 1997 after graduating from American University, and since then it has taken the world of higher education like frat boys storming a football field. More than 2,000 schools are using Blackboard as this term opens, including more than

half of all U.S. colleges and universities. The \$53 million that Blackboard raised in an initial public offering this June will help it continue this overhaul of education. "In the next 10 years online teaching and learning will be part of the DNA of educational institutions," says Pittinsky 32, Blackboard's chairman.

The technology doesn't replace classroom instruction, as many online schools do. Instead, Blackboard is designed to complement what happens in class. It gives students one centralized site on the Net to get course outlines, lecture notes, and reading materials. It also lets them take tests, hand in papers, watch videos, and participate in cyber-discussions that can bolster in-person lectures.

Consider one course taught at Georgetown, *Shall Microbes Inherit the Earth?* Before each class, assistant biology professor Heidi G. Elmendorf starts a discussion online so the face-to-face discourse can take off from a higher plane. Each of the 55 students is required to make at least one posting. One online session started with students relating their own experiences of popping antibiotics for the sniffles and morphed into sophisticated observations on how overuse of the drugs makes bacteria more resistant to antibiotics. Says Carrie Andolina, a Georgetown junior who took the class last year: "I'd rather respond to something another student suggested than read a paragraph and write about it."

GEORGETOWN Web discussion is a big help

Have Laptop, Will Blackboard

Blackboard's software is used in more than 2,000 schools, mostly U.S. colleges. Now it's gaining attention in K-12 and foreign universities. Here's why:

ECON 101 To supplement, not replace, classroom instruction, Blackboard puts course information on the Net. Students can get their syllabus, assignments, reading materials, and grades at a course's Web site, as well as take tests and hand in papers online.

SIGMA DELTA TAU Blackboard puts everything from fraternities and student government to the chess club and health care online. That makes it easier to find information and communicate with campus groups.

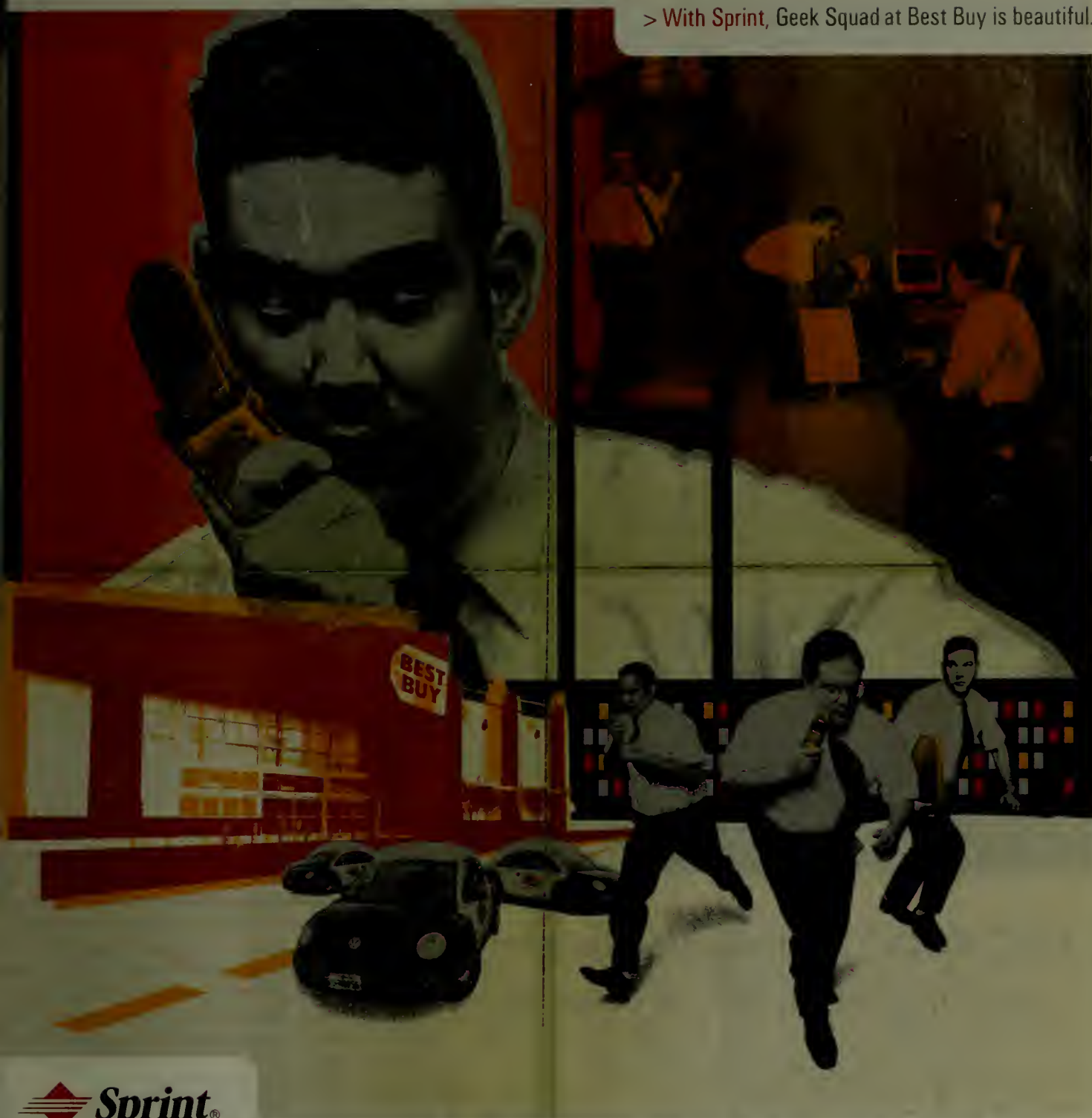
DINING HALL PLANS Blackboard offers a payment system that helps turn student ID cards into debit cards. Students can swipe their IDs to pay for dining-hall fare, laundry, and books, and go online to transfer funds to the card from a bank account.

ROOM TO GROW

BLACKBOARD IS CHANGING extracurricular life, too. The technology lets schools put everything from fraternity Web sites to health-care services online. Blackboard also provides a system that lets students use their ID cards as debit cards. They can swipe their IDs to pay for books, laundry, or late-night munchies. And the payment system lets them go to the Web to check past transactions or the remaining balance on their cards. If her balance is low, Georgetown's Caselli can use the Blackboard site to transfer money from her bank to her university account.

Pittinsky thinks the company has plen-

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ty of room to grow. Blackboard has publicly targeted annual growth of 20% to 25%. One reason: Some 86% of its customers buy only one of its five products, according to estimates from Merrill Lynch & Co., so there's plenty of opportunity to sell more products to existing clients. On top of that, Blackboard is increasingly targeting American K-12 schools and foreign universities, markets that Credit Suisse First Boston figures are worth about \$2 billion. CSFB projects that the company will boost revenues 19% this year, to \$110 million, while it earns \$7.8 million, compared with a loss of \$1.4 million last year.

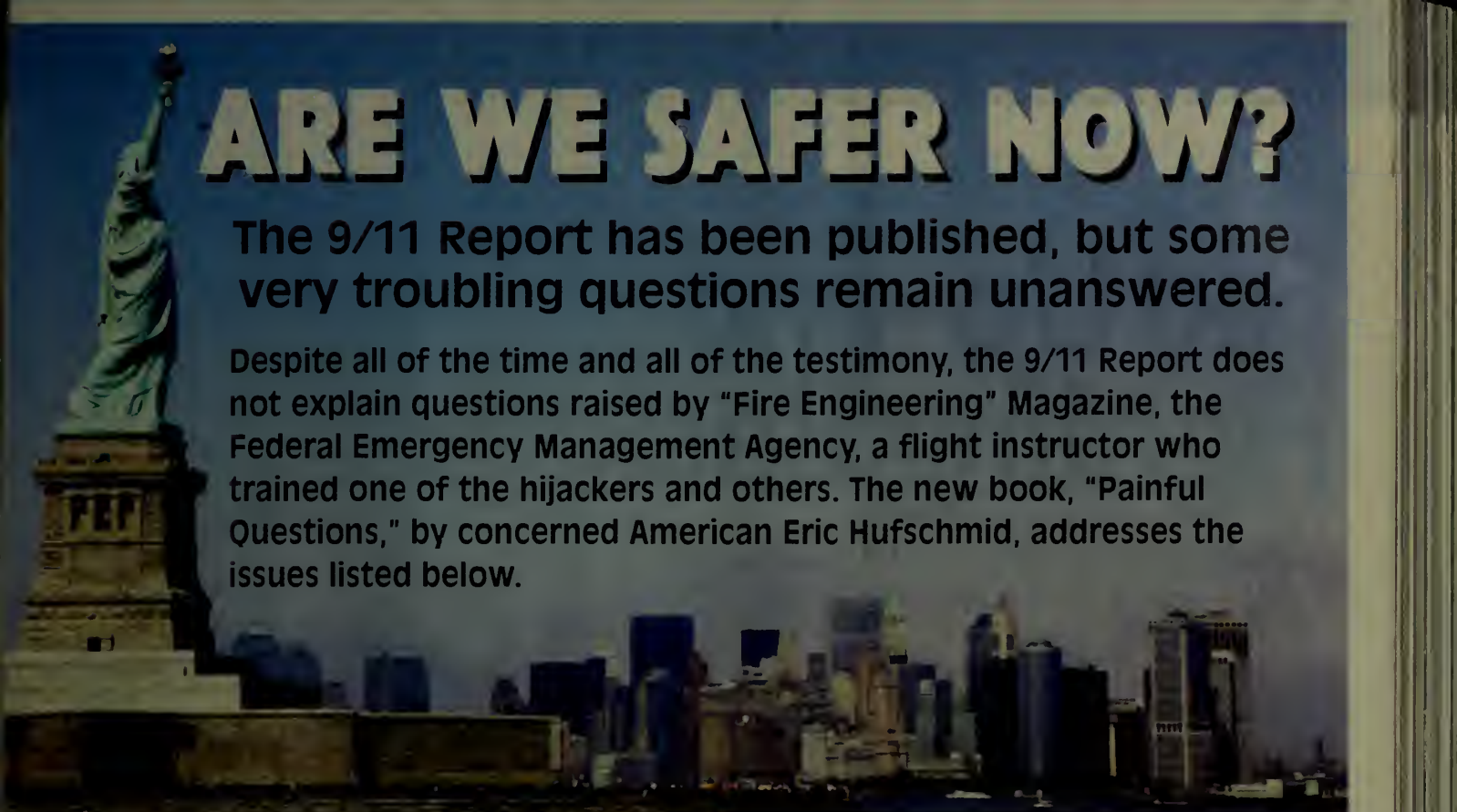
NO NEW HIRES NEEDED

BLACKBOARD FACES an array of smaller competitors. But the biggest threat lurks in the leafy groves of academe. The Sakai Project, an open-source software initiative led by Stanford University, Massachusetts Institute of Technology, the University of Michigan, and the University of Indiana, offers the prospect of free software to budget-conscious schools. The \$6.8 million project has already launched the first version of its offering. "There's no way a centralized system can innovate fast enough to keep up with all this stuff," says Bradley C. Wheeler, Sakai's vice-chairman.

Still, the most likely scenario is that Blackboard and other commercial software will coexist with open-source products. The key reason: Free software requires technical support, and only the largest universities typically have enough techies on staff to manage it. "A Blackboard license costs roughly the same as a senior programmer's \$100,000 job," says Serge Goldstein, academic services director at Princeton University, a Blackboard customer. "If you hire an additional staffer [to tend to the software], you've just blown your savings."

As Blackboard and its rivals slug it out, teachers are figuring out new ways to take advantage of the fast-evolving technology. For one exam, Duke University history professor John Herd Thompson used Blackboard to juxtapose two video clips. One, from *True Grit*, showed John Wayne's bloody shootout with Ned Pepper, while the other showed Canadian Mountie Sam Steele facing down a desperado without drawing a gun. Wayne riddles his nemesis with holes; Steele says: "Men don't wear pistols in Canada." Students then wrote an essay comparing perceptions of the U.S. and Canadian Wests. With John Wayne shooting it out on students' laptops, getting an education may never be the same. ■

—By Catherine Yang in Washington



ARE WE SAFER NOW?

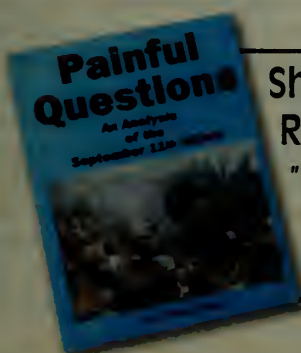
The 9/11 Report has been published, but some very troubling questions remain unanswered.

Despite all of the time and all of the testimony, the 9/11 Report does not explain questions raised by "Fire Engineering" Magazine, the Federal Emergency Management Agency, a flight instructor who trained one of the hijackers and others. The new book, "Painful Questions," by concerned American Eric Hufschmid, addresses the issues listed below.

- "No steel building has ever been destroyed by fire." *FIRE ENGINEERING MAGAZINE*
- The South Tower fell after only 1 hour. The North Tower fell one hour later. After the initial fireball, neither building burned significantly. The Meridian One Building in Philadelphia burned fiercely for 19 hours and never collapsed.
- Building 7 at the WTC, steel and constructed differently from the twin towers, fell at 5:30. It was not hit by an airplane and had no apparent significant fire.
- Jet fuel burns at too low a temperature to harm steel. (the black smoke indicates that the jet fuel was not even burning at maximum temperature.) And the fires did not burn long enough to harm steel.
- Days later, there were still "hot spots" in the building that exceeded the maximum temperature possible from burning jet fuel, but just the right temperature if explosives had been used.
- The concrete clouds shooting out of the buildings are not possible from a mere collapse. They do occur from explosions.
- The buildings collapsed at the maximum speed of gravity. That is almost impossible without explosives.
- The impact of the airplanes and the resulting fires were way off center. More than 2 sides of the towers and the main center columns were untouched. Why did all three buildings collapse?
- "The specifics of the fires in WTC 7 and how they caused the building to collapse remain unknown at this time." *FEDERAL EMERGENCY MANAGEMENT AGENCY*
- F-16 fighters are supposed to form an umbrella over Washington in an emergency. The Pentagon was attacked over AN HOUR after the second aircraft hit the WTC. Why were no fighters scrambled?

"I was so impressed with this book and the questions it raises that I will send a FREE COPY to any fire station, police precinct, judge or politician that requests it.

James W. Walter, Jr.



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Fed Up—and Fighting Back

After years of discrimination, women on Wall Street are turning up the heat

WHEN ANNE P. Kaspar, a veteran financial adviser, joined Morgan Stanley's office in Santa Fe, N.M., in August, 2003, the scene felt all too familiar to her. The former plaintiff in a sexual discrimination class action brought against Merrill Lynch in 1997 thought she was going to give investment advice as soon as she renewed her broker's license. Instead, Morgan Stanley sent Kaspar to a three-year training program with a bunch of rookies, and Kaspar alleges her boss forbade her from cultivating clients even after she had secured her license, unlike less seasoned male colleagues.

Instead of suffering in silence for years, Kaspar complained to her boss about unfair treatment just four months later. By May, Morgan Stanley fired her for "insubordination." Kaspar filed a sexual discrimination claim with the U.S. Equal Employment Opportunity Commission in which she said there are enough women in Morgan Stanley's retail-brokerage operations who are experiencing discrimination to form a class action, according to documents reviewed by *BusinessWeek*.

Morgan Stanley says Kaspar was hired as a

trainee, the job she applied for and that she was not disadvantaged relative to her male colleagues. She was "not qualified to work as a financial adviser" since she had not been registered for five years and had never been through a formal training program. The EEOC, which struck a \$54 million settlement with Morgan Stanley in July for allegedly discriminating against hundreds of women in its bond business, declined to comment.

Kaspar's battle with Morgan Stanley illustrates a new, more aggressive phase in the battle for women's equality on Wall Street. Frustrated by a lack of progress in an industry still dominated by men,

women are fighting on several fronts. They are filing a rash of new lawsuits, some of which should make their way to courts this fall. Others are lobbying internally for change. A third camp is deserting the business altogether. "When I started on the Street, firms could bash your head in and you'd stay. Now many women are saying, 'see ya,'" says Janet Hanson, who left Goldman, Sachs & Co. to found her own money-management firm in 1994 and joined Lehman Brothers Inc. in May as a managing director hired specifically to help recruit and retain women.

Arguably, women have made progress in recent years, although

their clout is still less than in many other industries. Since 1976, when the EEOC settled its first sex discrimination class action against a Wall Street firm, Merrill Lynch, the percentage of the firm's brokers who are women has more than tripled—but they account for only 15% of the total. And only 10.6% of Wall Street's corporate officers are women, vs. 15.7% for other industries on average (table).

SEXUAL PRANKS

WORSE, DESPITE YEARS of legal battles and bad publicity, some firms' cultures apparently still tolerate sexual pranks. A presentation book shown as a joke to client GMAC Mortgage Corp. last fall by Deutsche Bank Securities Inc. employees contained lewd biographies of male and female investment-banking-team members. It described the one female on the team, who is still at the firm, as a "legend of the adult film industry under her stage name Roxy Lovejoy" and as a second-rate porn star in a film named "Plump Fiction." The bios came to light after a former Deutsche Bank employee filed a reli-

Behind the Times

Fewer women make it to the top in the securities biz than in most other industries

PERCENTAGE OF CORPORATE OFFICERS WHO ARE WOMEN	
Insurance*	31.0
Tobacco	29.7
Entertainment	26.7
Apparel	24.7
Publishing	22.5
Health Care	21.9
All Industries	15.7
Securities Industry	10.6
Computer Software	10.4

* Property and casualty

Data: Catalyst Census



MAN
is taking
case
inst Morgan
ley to court

KASPAR
She filed a
claim against
the firm with
the EEOC



rious discrimination lawsuit in New York State Supreme Court on Sept. 7 about the prank. Both Deutsche Bank and GMAC Mortgage declined comment.

Men and women on Wall Street don't even agree that there's a problem. While 65% of women on the Street believe they have to work harder than men to get the same rewards, only 13% of men share their opinion, according to a recent study by research organization Catalyst Inc. Even fewer men—just 8%—concur with the 51% of women who say they're paid less than men for doing similar work.

A slew of sex discrimination cases are working their way through the system. Until now most women have settled their cases for chump change, leaving their stories untold and questions unanswered. But stalwart claimant Nancy Thomas, who has insisted on a hearing ever since filing her claim as part of the class action against Merrill Lynch, is expected to testify that someone left a dildo, lubricating cream, and debasing poems on her desk. Merrill says it diligently investigated the incident and was unable to identify the offender.

Women are also increasingly exposing—or finding ways to get around—practices that they say have hurt their cases. Former Morgan Stanley broker Elizabeth “Lisa” Neuman, who worked in Somerville, N.J., plans to appeal the summary judgment by a federal court that dismissed her sex discrimination claims. She is also suing the firm for allegedly breaching its employment agreement with her. Morgan Stanley believes the case has no merit.

BusinessWeek has learned that Pamela K. Martens, lead plaintiff in the landmark 1996 class action against Smith Barney, has asked the state presidents of the National Organization for Women to investigate the role that former President Patricia Ireland had in the Smith Barney and Merrill Lynch class actions. Martens claims that Ireland asked women at Merrill, some of whom were plaintiffs, to share their complaints and suggestions for improving the firm without disclos-

ing if she was working for Merrill. *BusinessWeek* reviewed e-mails from Ireland to the women and they did not reveal the Merrill connection, though Merrill and Ireland say the women were informed of her role.

Women who are not filing lawsuits, especially those who have risen in the ranks, are waging a battle from a different perspective. At J.P. Morgan Chase & Co., Chief Financial Officer Dina Dublon, as a member of the senior management team, has a say in how many women are promoted at each level of the organization as well as whether they are being considered as candidates for job openings. On another front, women are trying to persuade the banks to adopt more flexible employment policies, such as job sharing even on trading floors and allowing them to work one day a week from home.

DROPPING OUT

OTHER WOMEN are just leaving. According to the Securities Industry Assn., the percentage of women on Wall Street overall has declined to 37% in 2003, vs. 41% in 2001. And the percentage in executive management positions fell to 17% in 2003, vs. 21% in 2001. “Many of my friends dropped out because Wall Street was unwilling to provide a career path that incorporated the reality of family needs,” says Deborah C. Wright, chief executive of Carver Bancorp, who worked at First Boston in the 1980s.

What's particularly worrisome is that more women are leaving the Street long before they actually have families. “A fair number of women look ahead and say ‘man, this is never going to work,’” says Katie Higgins Hood, 30, director of research programs at the Michael J. Fox Foundation for Parkinson's Research and a former Goldman Sachs analyst.

If current trends continue, Wall Street may become even more of a man's world than it was in the 1970s. “Women have gained no ground on Wall Street in the past eight years,” Kaspar fumed in capital letters and bold type in her affidavit to the EEOC in May, before firing off an open letter to Morgan Stanley CEO Philip J. Purcell and the firm's board of directors in August. Purcell has not responded. The firm maintains that it dealt with the issues through its attorneys before the letter was sent. ■

—By Emily Thornton, with Mara Der Hovanesian and Jennifer Merritt, in New York

The overall percentage of women on Wall Street is slipping

Meet the Friendly Corporate Raiders

When Relational Investors buys in, the board often takes its advice without a fight

RALPH V. WHITWORTH and David H. Batchelder have two of the trickier jobs in the money-management world. They buy a chunk of an ailing company, say Mattel or J.C. Penney or Waste Management, then politely tell the board it should be doing a much better job before prodding, cajoling, and twisting arms to get their way.

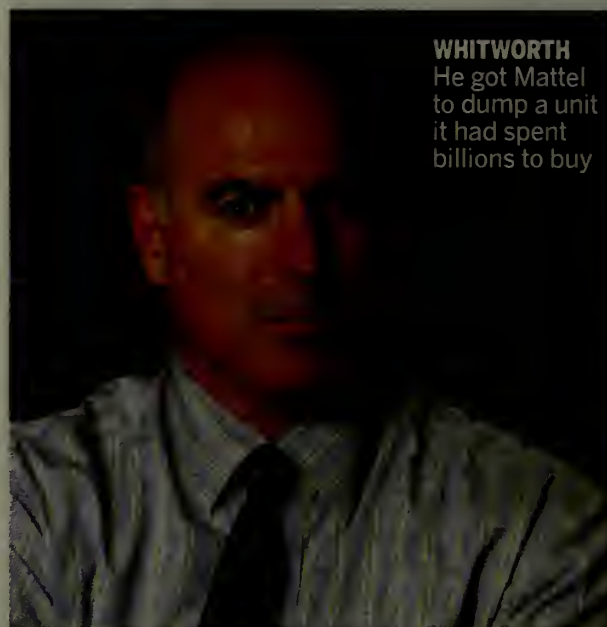
Sometimes doors get slammed in their faces. Sometimes a chief executive seethes with resentment. But usually the company comes around—and Whitworth and Batchelder walk away with a huge gain on their shares. “Most of the

time, management agrees that its stock is undervalued and knows what’s causing it,” Batchelder says. “It’s just a question of the timing of the fix.”

The two run San Diego-based Relational Investors, and their mentor, legendary corporate raider T. Boone Pickens Jr., would be proud of their results. In its eight-

year history, the firm has racked up an average annual return of 21%, more than doubling the performance of the Standard & Poor’s 500-stock index. In that time, its assets—the fund is open only to institutional investors—have grown from \$200 million to \$3 billion.

Few firms have been able to pull off a similar strategy—talking boards into making tough changes—much less match Relational’s record. Shareholder



WHITWORTH
He got Mattel to dump a unit it had spent billions to buy

activists Nell Minow and Robert Monks sold their money-management business several years ago after finding it hard to generate market-beating returns when it can take years to show results from each company. “I tend to get impatient with people,” says Minow. “Ralph and

David are more consensus-builders.”

The California Public Employees’ Retirement System gave Relational its seed money but has had mixed results with its six other activist funds. CalPERS remains Relational’s largest investor, putting in nearly \$1 billion.

CLEAR FOCUS

THE RELATIONAL FORMULA is surprisingly simple. Whitworth, Batchelder, and a staff of 12 analysts comb through databases for companies with a strong core business but a stock price that seems depressed. A closer look often shows a company plagued by management mistakes. Relational then buys a stake and presses for change in meetings with execs and board members.

Whitworth and Batchelder don’t spread themselves too thin: Relational usually holds stakes in no more than 12 companies—it figures that’s enough works-in-progress to handle at a time. Right now it’s invested in 11 companies.

Frequently, Whitworth’s and Batchelder’s prescription calls for ditching an underperforming unit. After winning a seat on Mattel Inc.’s board in early 2000, Whitworth persuaded management and his fellow board members to dump the company’s money-losing computer-game business, Learning Co., less than a year after Mattel bought it for \$3.5 billion. “That was strong medicine,” recalls Mattel’s chairman and CEO, Robert A. Eckert, who joined Mattel after the Learning Co. deal. “Ralph had done a lot of homework. After we did it, the stock went up.”

In the past year, Relational has



BATCHELDER The team met working for T. Boone Pickens Jr.

A Profitable Kick In the Pants

Relational Investors buys stakes in beaten-down companies, aiming to profit by fixing their strategies. Some current holdings:

COMPANY	STAKE	FIX
ConAgra	2%	Boost returns on the food processor’s packaged-food products
CNF	9.8	Divest the transportation outfit’s flagging freight-forwarding business
J.C. Penney	4.8	Buy back stock after the sale of the retailer’s drugstore chain
Mellon Financial	2.0	Dump the firm’s noncore human-resources unit
National Semiconductor	6.3	Exit low-margin product lines
Prudential Financial	2.2	Sell the insurer’s weak units and increase stock buybacks

Data: Relational Investors

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pushed retailer J.C. Penney Co. to sell its flagging Eckerd drugstore unit and National Semiconductor Corp. to shed some of its weak digital-chip businesses to focus on analog chips. Both companies took Relational's advice and their stocks soared, contributing to Relational's 2003 return of 48%. The fund was up 11.6% in the first half of this year, vs. 3.4% for the S&P 500.

COSTLY LESSON

NOT ALL OF THE PAIR'S forays have been successful. After Relational's 1997 investment in oil-and-gas producer Nuevo Energy Co., Whitworth and Batchelder got the company's chairman and CEO to step down, eliminating his expensive management contract. But Nuevo's reserves didn't prove as valuable as the pair had hoped, and Relational sold its shares six years later, taking a loss of over 70%. They vowed never to invest in a commodities-based business again.

In pursuit of their goals, Whitworth, 48, and Batchelder, 55, have never had to wage a proxy fight. Through their badgering—and, no doubt, the threat of a fight—they've gotten themselves on the boards of half a dozen companies, including giant ConAgra Foods Inc. and home health-care provider Apria Healthcare Group Inc. Once on the board, Whitworth and Batchelder remain only long enough to get their changes implemented. "Ralph in the boardroom was a clear voice for shareholders," says A. Maurice Myers, chairman of trash hauler Waste Management Inc., where Whitworth helped replace the CEO and shift the company from acquiring businesses to managing better the ones it had. "His focus is always on the allocation of capital to its highest and best use."

Whitworth met Pickens while working as a U.S. Senate staffer in Washington in the early 1980s. That led to a job at Pickens' oil-and-gas firm, Mesa Petroleum. That's where Whitworth, a lawyer by training, first teamed up with Batchelder, an accountant. The two helped Pickens with many of his famous takeover battles in the mid-'80s, including his runs at Phillips Petroleum and Unocal. After leaving Mesa, Batchelder and Whitworth each formed his own investment-advisory business before joining forces at Relational in 1996. Call them the kinder, gentler corporate raiders. ■

—By Christopher Palmeri
in San Diego

Is James Bond Worth \$1 Billion?

MGM's franchise is juicy, but any new owners need to sharpen 007's edge

HOW MUCH is 007 worth? That's a key question for Sony and Time Warner as they sic their number crunchers on Metro-Goldwyn-Mayer, which controls the James Bond franchise—and is on the block. The British secret agent has sold \$3.7 billion in tickets since Sean Connery donned the tuxedo and eyeballed the first Bond Girl in 1962's *Dr. No*. But can Bond stay as daring, dashing, and—of course—profitable as always?

From the prices being batted around, MGM owner Kirk Kerkorian should get \$4.6 billion to \$4.8 billion for the famed studio. There's little debate over the value of MGM's 4,000-film library, which includes *The Pink Panther*, *Rocky*, and the 20 Bond flicks. It earns an estimated \$450 million a year. That would make the library worth \$3.6 billion, based on the standard formula of eight times cash flow for libraries. And that means Bond accounts for most of the remainder of MGM's value.

But is 007 really worth \$1 billion? Douglas L. Lowell, a longtime industry analyst, puts the franchise at \$623 million. That includes the windfall each time a new Bond film arrives in theaters and the older flicks—all 20 of them—are repackaged as DVDs that generate \$25 million to \$50 million a year. Hollywood veteran Amir J. Malin figures that the next four Bonds

alone are worth \$500 million, based on a profit of at least \$125 million per release. But if the winner of the MGM derby can keep the franchise going strong, he guesses it's a \$1 billion property.

From such differences, deals sometimes crater. The 87-year-old Kerkorian may decide to take MGM off the market—he has done it before—but there are hints a deal could come this month. MGM declined to comment.

So how might Sony or Time Warner justify \$1 billion for Bond? Perhaps by taking more steps to focus the franchise on younger moviegoers, as MGM has done by making Bond videos for MTV. The latest Bond, 2002's *Die Another Day*, grossed \$413.9 million, but that doesn't match the hotter franchises Hollywood is building, such as *Spider-Man*. A new owner might try a cutting-edge director such as *Kill Bill*'s Quentin Tarantino, who says he wants to remake the farcical 1967 *Casino Royale*.

The current Bond, 51-year-old Pierce Brosnan, has said he may soon turn in his license to kill. *X-Men*'s Hugh Jackman and *Pirates of the Caribbean*'s

Orlando Bloom are possible successors. As MGM did by getting Brosnan in 1995, the right blend of actor, director—and maybe a little more skin—could well make Bond a \$1 billion man. Doubtless, he's still got a lot of bad guys left to battle. ■

—By Ronald Grover in Los Angeles



Brosnan, 51, says he may turn in his license to kill

Can Caddy's Driver Make GM Cool?

Mark LaNeve is out to put the verve back in the carmaker's sluggish brands

THERE IS NO DOUBT THAT Mark LaNeve has earned his stripes as an auto-industry marketer. As head of Cadillac since 2001, he has been a key player in engineering one of the most impressive turnarounds the industry has seen in recent years. Cadillac's rock 'n' roll campaigns featuring Led Zeppelin music and showcasing the new generation of tire-burning luxury cars injected energy into a brand that many had written off as sclerotic. And he tirelessly flew

to meet with Caddy's 1,500 dealers and convince them the brand wasn't dying.

Now the former University of Virginia linebacker has an even bigger challenge. This month, General Motors Corp. promoted LaNeve to head of marketing for all of its brands. His task is daunting. GM's weakest units—Buick, Pontiac, and Saturn—are clawing back after years of market-share slide, stagnation, and mismanagement. Any recovery will have to be won in a weakening market: In August, GM's sales slipped 7%, prompting the company to slow its plants for the

fourth quarter to clear out bloated stocks. Market share has fallen to 27.2% from 28% last year. It now takes GM an average of 91 days to move vehicles off dealer lots—twice what it takes Japanese companies in the U.S. For months, some GM execs wore lapel pins with the number 29, the company's market-share target. But with some analysts predicting a slide to 23% by the end of this decade, those pins are now as current as "Howard Dean for President" buttons.

REBATE CONTROL

WITH ALL THIS working against him, can LaNeve make GM's brands cool again? The task is daunting. GM remains strong in trucks, but in recent years the company has not replaced its car models as fast as Toyota, Honda, and others. Now it's trying to catch up, and new vehicles are on the way. LaNeve and his team will have to craft consistently compelling ad campaigns—traditionally not a GM strength. He has to convince shoppers that the new metal is worth buying without lots of rebate cash. And he will have to work on consumer perception that GM's cars—despite rising in the ranks of J.D. Power & Associates Inc. quality surveys—aren't built as well as foreign models with lower scores, such as Volkswagen. "I look at Nissan five years ago or Hyundai six

GM's **Neediest** Cases

The most pressing challenge facing new U.S. marketing chief LaNeve is finding ways to revive GM's slipping brands.



CHEVY The trucks are old, and even the new cars lack compelling styling. "An American Revolution" ad campaign shows promise. The Cobalt compact is an improvement over the ancient Cavalier but breaks no new ground.



BUICK Reviving Buick could be like trying to sell LP records in an iPod world. Its average customer is 63 years old, and it relies heavily on big rebates and sales to rental fleets. The new LaCrosse sedan is a snooze.



PONTIAC It's hard to see how Pontiac will ever be known as a poor man's BMW. The 2005 G6 has a lot to prove.



SATURN This once-hot brand is desperately seeking a strategy and credible new products. Current models are floundering, and the new Relay may suffer from looking too much like GM's other minivans. Can Saturn recapture its "customer experience" focus?

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CenterPoint Energy is a domestic energy delivery company with 11,000 employees serving nearly five million customers from the Gulf Coast to the Great Lakes. Several years ago, CenterPoint Energy began deploying an SAP platform to improve business processes around its human resource and financial systems. While this promised savings and productivity improvements, the company confronted training and change management challenges.

The traditional training approach would require flying employees or instructors to various locations - resulting in a loss in productivity and high travel costs. According to Larry Stewart, CenterPoint Energy's Human Resources Information Systems (HRIS) Manager, "The cost of sending employees to a training session becomes substantial when there are 40-50 people to train."

CenterPoint executives turned to Centra to deliver the training online to thousands of remotely located employees, eliminating travel-related and audio conferencing expenses, and allowing the delivery of courses in a more flexible manner.

"Centra paid for itself in the first six months," Stewart says. By using Centra to engage people online and demonstrate the look and feel of SAP virtually, the company was able to reduce apprehension about the change and quickly gain widespread user acceptance - resulting in a faster and more efficient rollout of SAP.

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years ago," LaNeve says. "Turnarounds can come that fast."

LaNeve was helped at Cadillac by respectable new products, such as an Escalade SUV that hit big with the hip-hop crowd and a CTS sedan that impresses even Lexus lovers. He needs the new Pontiacs, Saturns, and Buicks to make marks as well—and not just in rental-car lots. GM is spending plenty to do it. After shelling out \$4.3 billion to develop new Cadillacs, it's dropping \$3 billion on Buick and nearly as much on Saturn.

SWERVING BRAND IMAGES

GM HAS PAID A HEAVY toll for its three-year price war in lost profits and brand image. Consumers are trained to look for GM's deals. The auto maker averages \$7,200 a vehicle in total discounts, vs. \$5,000 industry-wide, says Edmunds.com Inc. That's a 23% discount off sticker prices, compared with 21% at Ford Motor and 10% for Japanese brands.

LaNeve thinks marketing can make a difference. He wants to offer deals more selectively. "We aren't backing away from using incentives," he says. "But we need to look harder at: 'Are we spending the right way?'" Says Iceology consultant Wesley R. Brown: "The Big Three ads make it sound like a fire sale, so it sounds desperate."

Maintaining a consistent image has been a big problem for GM's car brands. Buick has tried three marketing strategies in six years, employing tactics from talking cows to a series of creepy ads depicting the ghostly image of long-deceased GM designer Harley Earl—an industry legend with little recognition outside automotive circles. Yet another Buick strategy breaks later this month. Pontiac drew the public scorn of GM Vice-Chairman Robert A. Lutz two years ago with a reality-show style ad campaign featuring young people being surprised by the Pontiac driving experience. Pontiac gets its second strategy in two years this month. And struggling Saturn goes back and forth between selling its no-haggle showroom message and chancy "mood" ads about vehicle design and the free spirit of Saturn buyers. LaNeve says there are no sacred cows among GM's ad agencies, some of which have been on the job for decades.

Earlier this year, GM dismantled the last pieces of an ill-conceived packaged-goods brand-management system installed in the mid-1990s by former GM

North America President Ronald Zarell. Under Zarella, advertising focused on specific models like Regal and Grand Prix rather than brands. Market share fell, but LaNeve believes GM's problem brand need clear emotional campaigns that hold up for years. Says a colleague who has endured GM's flailing: "Mark has great instincts...and is in charge of making sure nothing really awful gets on the air anymore."

LaNeve needs to find a logical marketing niche for each brand to pursue. There, GM has set some ambitious targets. It wants to make Buick a low-priced alternative to Toyota's posh Lexus brand. And Pontiac is to be aimed at buyers who yearn for the performance of a BMW without the hit to the wallet. New cars such as this fall's GM

midsize car and next year's sexy Solstice two-seater will feature tight handling and fast engines to sell the idea. Saturn is moving closer to Honda and Volkswagen with Euro styling and expensive-looking interiors. "Except for Cadillac, Chevy Truck, and Hummer, all those brands want to be seen differently by consumers than they are today and that is a lot of change to

engineer," says Dan Gorrell of San Diego consultant Strategic Vision.

The toughest part will be getting import shoppers to even take a look. Buick's buyers today are mostly GM loyalists. The same goes for Pontiac, though it has among the youngest buyers of any domestic brand. Saturn's image lures import shoppers, but its best new vehicles are a couple of years away. The vestige of goodwill for Caddy LaNeve had in his old job is in short supply at these other brands. "None has the positive publicity and word of mouth of Cadillac," says analyst Tom Libby of Power Information Network LLC.

LaNeve's task will be downright impossible if the new models don't sizzle. And so far, reception by the national auto press to the new Buick LaCrosse, Pontiac G6, Chevy Cobalt, and GM's new minivans, all debuting this fall, has been tepid. LaNeve looks at the situation like a football coach of a former powerhouse team fighting to regain respect. "GM is the underdog now," he says. "We are the scrapper. That's how I am going into this." It worked at Cadillac. Now, LaNeve needs to make it work for an entire corporation. ■

—By David Welch in Detroit and David Kiley in New York

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After Centra.

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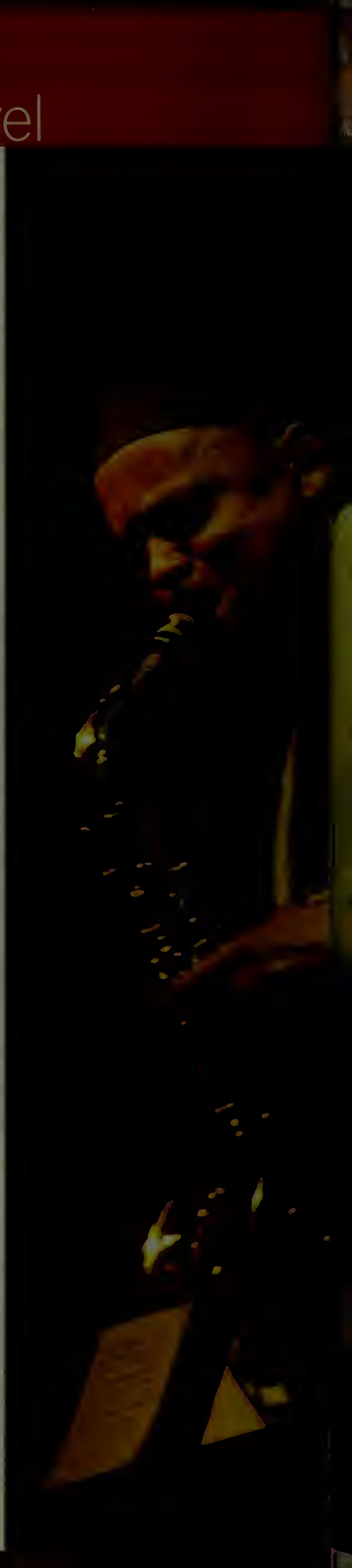
Five Jaunts for A Jaded Executive

These itineraries would intrigue even the most well-traveled businessperson

THE HOME OFFICE just called to say the boss is blowing into town, and you're responsible not just for arranging the business meetings but for planning the entertainment as well. This isn't the first—or even the fifth—time this person has passed this way, so hitting the well-known restaurants and tourist destinations won't do.

Whether you're expected to serve as a personal tour guide or just make suggestions, you'll have to design an itinerary that isn't in every guide book. What do you do? ¶ We put that question to five *BusinessWeek* writers in locales an executive might visit. Using their inside knowledge of the cities they live and work in, they've come up with a list of places they would choose if they were put on the spot. From a Manhattan outing that focuses on the culture and cuisine of Harlem, to a California wine country trip that takes in art treasures, to Paris and Tokyo as lived by the locals, these schedules can intrigue even a jaded traveler. Now, all you have to do is make the boss believe everything was your idea. —Carol Marie Cropper

JENNIFER S. ALTMAN; MAPS BY RAY VELLA/BW



Harlem On My Mind

Black America's cultural capital is thriving again.

BY ROBERT McNATT



YOU'VE ALREADY visited the Metropolitan Museum, seen a Broadway show, and caught a game at

Yankee Stadium. But New York's truest glory is the breathtaking diversity of its people and their communities. So on your next business trip to the Big Apple, spend some of your down time in one of its most storied neighborhoods: Harlem. In the past decade, the historic capital of Black America has blossomed. As gentrification has taken hold, the crime rate has plummeted, brownstone homes now sport million-dollar price tags, and the streets and avenues are filling with new shops and restaurants.

The heart of the community is the bustling section of 125th Street between Eighth Avenue, also known as Frederick Douglass Boulevard, and Fifth Avenue. Make your first stop The Studio Museum in Harlem at 144 W. 125th St., a jewel box of a showcase for works by artists of African descent. Some of them are in the museum's artist-in-residence program, so you'll get first crack at viewing original pieces. But with its public seminars and programs, the museum's offerings regularly go beyond the visual arts. This summer, for example, you could have taken a walking architectural tour of Harlem, listened to a program of new orchestral music by composers under the age of 30, or explored the history and culture of tap dancing. Check out the museum's Web site, studiomuseum.org,

ART DECO COOL
The Lenox Lounge in full swing

Personal Business Travel



for a complete schedule of programs.

No one who visits Harlem should miss the Apollo Theater at 253 W. 125th St., which helped launch stars such as Ella Fitzgerald and Lauryn Hill. On Amateur Night every Wednesday at 7:30 p.m., new hopefuls try to wow the Apollo's legendarily tough audiences—who make *American Idol*'s Simon Cowell look downright demure. A single admission is \$18 to \$39 depending on the performance. Or you can see the theater by calling ahead for a backstage tour (212 531-5337). They're offered only for groups, but you can easily join one already scheduled.

UPTOWN LOOK

AFTER A THEATER TOUR, stroll east on 125th Street through street vendor territory with table after table of books, posters, incense, and CDs. You'll pass the building at No. 55 West where former President Bill Clinton has his office. On the same block you can stop and grab a quick snack from Wimps Southern Style Bakery at No. 29 West. Its peach cobbler, banana pudding, and sweet potato pies, among other favorites, will smite whatever carb-cutting impulses you have.

Your sweet tooth satisfied, meander over for some shopping at one of Harlem's most interesting boutiques, The Brownstone, at 2032 Fifth Ave., just north of 125th Street. Operating from three floors in one of the typical narrow city dwellings that line so many streets in New York, The Brownstone is a stylish emporium of de-

lights. You can order custom-made dresses and wedding gowns, but moderately priced ready-to-wear women's apparel is also for sale. Some men's shirts and pants are available as well. The owner describes the offerings as contemporary Afro-ethnic. You can complete that uptown look from a selection of jewelry, accessories, and cosmetics. One floor here also offers a hair salon and manicure services, and in mid-September, a café is slated to begin serving. The Brownstone is open Wednesdays through Sundays.

Eating in Harlem is an experience unto itself. At Malcolm X Boulevard (also called Lenox Avenue) and 127th Street is the venerable Sylvia's, perhaps the city's best-known soul food restaurant. Twenty years ago it was a sliver of a place where locals munched on ribs and greens at its long narrow counter and listened to the juke box, while peddlers wandered in selling everything from new shoes to floor-waxing machines. Today the joint has expanded and the peddlers are gone, but the Southern menu has mostly remained the same. A gospel brunch on Sundays at 12:30 p.m. is also a big draw. Get there early: No reservations are taken.

A bit further south, at 113 W. 116th St., is Amy Ruth's Home Style Southern Cuisine, which some think is giving Sylvia's a serious run for the money. For some-

thing different, try the honey-fried chicken. What makes it unique is that the honey doesn't come from a jar but from beehives

on the restaurant's roof. Many of the dishes are named after local African-American notables. Chicken and waffles, for instance, is called the Reverend Al Sharpton because that specialty is a favorite of the well-known activist. Amy Ruth's is also open all night on Fridays and Saturdays.

There is a nonculinary attraction here too: The photos, paintings, and sculptures displayed in the two-story eater are for sale at prices generally ranging from \$200 to \$3,000.

After dark catch some jazz at one of the classiest Art Deco locales in Manhattan, the Lenox Lounge on Malcolm X Boulevard between 124th and 125th. First opened at the tail end of the Depression, it once showcased the likes of Billie Holiday

and Miles Davis. The much-photographed classic interior has been restored, and the scene in the Zebra Room in the back, with its animal-print walls still swings. Check lenoxlounge.com for a list of who's playing. On weekends, when bigger names perform, there is a \$15 person cover charge with a one-drink minimum. Altogether, it's a great place to wind down after your uptown foray. ■

COMEBACK
Brownstones
are going for
high prices

**For soul
food, you
can try
Sylvia's
and Amy
Ruth's**

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5

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Where Wine and Masterpieces Mix

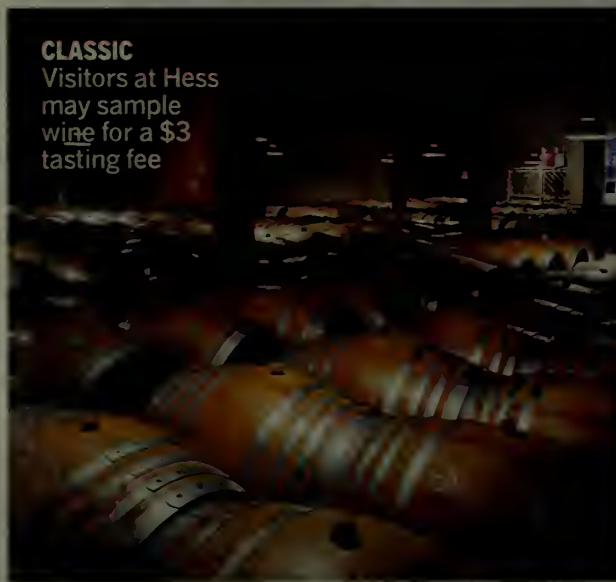
Napa Valley is home to some fine private collections that are open to the public. **BY LINDA HIMELSTEIN**



CALIFORNIA'S NAPA Valley is synonymous with wine—from the vineyards dotting its sloping green hillsides to the award-winning chardonnays and cabernets served at the area's fine eateries. What you might not know about Napa, however, is that it's also home to some of the most impressive—and unique—private art collections in the world. Many of these gems, though off the well-trodden paths taken by most visitors, are open to the public. So if you're going to the wine country, duck the crowds and head to the galleries.

First stop: the fascinating di Rosa Preserve, located on the Carneros Highway (dirosapreserve.org). This 217-acre refuge

CLASSIC
Visitors at Hess may sample wine for a \$3 tasting fee



includes a 35-acre lake, two galleries, the original stone winery, and a tractor barn. Each venue, including the lake, is bursting with some 2,000 contemporary works from 800 Bay Area artists. Even the former home of art aficionado Rene di Rosa, who still lives on the property, is full of multimedia pieces.

The di Rosa collection, which opened in 1997, is eclectic. One sculpture is made entirely out of chewed gum. Another is a mound of scissors, corkscrews, and other items confiscated after September 11.

2001, by security at San Francisco's airport.

There's something for everyone here. Wildlife lovers will enjoy the numerous peacocks, geese, and herons. It's an adventure that can be experienced only through a 2½-hour guided tour (\$12). Reservations are a must, since groups are limited to 25.

The Hess Collection Winery at Mount Veeder, about 25 minutes from di Rosa, is only a bit more traditional (hesscollection.com). The emphasis is clearly on the fine Hess wines, which visitors may sample for a \$3 tasting

CONTEMPORARY
The Hess Collection gallery



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fee. But it would be a mistake to miss seeing the 115 contemporary artworks in the gallery. They include pieces by Francis Bacon, Frank Stella, and Robert Motherwell. One intriguing creation by Marcus Raetz is a series of faces made entirely out of eucalyptus leaves.

About 25 miles north of Napa in Calistoga lies Clos Pegase, a winery named for the mythic winged horse, Pegasus (clospegase.com). Owners Jan and Mit-

suko Shrem are avid collectors of modern art. Their most noteworthy works, by artists such as Henry Moore and Richard Serra, are on display in a sculpture garden. Don't miss the seven-foot bronze thumb by French sculptor César.

If photography is your thing, catch the ongoing exhibits at sparkling-wine producer Mumm Napa (mummnapa.com). Located along the picturesque Silverado Trail about 15 minutes north of Napa,

Mumm maintains a permanent exhibit featuring more than two dozen original photographs by Ansel Adams.

None of these places serves food. So you might want to stop in at Bistro Don Giovanni. It's one of my favorite spots in Napa Valley and it's on the way from Hess to Mumm and Clos Pegase on Highway 29. You will enjoy a first-rate meal and terrific wine. But don't forget: Napa isn't just about wine and food anymore. ■

An Arts Tour Of Two Cities

Dallas and Fort Worth have top-notch museums—and good eating besides. **BY WENDY ZELLNER**



AS ANY VISITOR will quickly discover, there's a lot more to Dallas and Fort Worth than the Kennedy assassination site and cattle-roping cowboys. The rival cities have become arts meccas, with lots of good eating to tide you over on your 35-mile trip in between.

If sightseeing time is limited, the place to start is Fort Worth. Head to the Cultural District, where you can visit five of the best museums in the Southwest, including the striking new Modern Art Museum designed by Japanese architect Tadao Ando. Don't like modern? Mosey next door to the world-renowned Kimbell Art Museum, including masterpieces

from Fra Angelico, Claude Monet, and Pablo Picasso, or the Amon Carter Museum, featuring a vast collection of American art from the likes of Frederic Remington and Georgia O'Keeffe. For Old West lovers, there's the National Cowgirl Museum & Hall of Fame. A few miles away you'll find the Stockyards National Historic District, where you can watch daily cattle drives.

No trip to this town "where the West begins" would be complete without melt-in-your-mouth barbecue. Two local favorites: Angelo's, where mounted animal heads complete the decor, and the Railroad Smokehouse, with plates of smoked ribs and sausage at modest prices.

After all that chow and museum-hop-

ping, the AA League Frisco RoughRiders might provide a change of pace during a summertime visit. The Dr Pepper/Sevens Up Ballpark opened last year about 20 miles north of Dallas and is winning acclaim from baseball fans. If you prefer a trendier crowd, the people-watching at Hotel ZaZa's Dragonfly restaurant in Dallas' Uptown neighborhood is almost better than its eclectic menu designed with the help of consulting chef Stephan Pyles. The elegant Abacus in the Knox-Henderson district offers creative dishes that fuse Southwestern and Asian flavors.

With another day to spend, you can squeeze in some of Big D's must-see attractions. Tops on the list is the new Nasher Sculpture Center, a light-filled museum and outdoor garden near the Morton H. Meyerson Symphony Center downtown. Donated by real estate developer and collector Raymond Nasher, the center is home to more than 300 sculptures by such artists as August Rodin and Picasso.

Weather permitting, consider a visit to one of the city's lushest oases: the 66-acre Dallas Arboretum on White Rock Lake. Some time amid the soothing fountains and towering trees is sure to make the plane ride home a bit more bearable. ■

STRIKING Tadao Ando's Modern Art Museum in Fort Worth



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S&P 500	-12.01%

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GO WITH THE FLOW The Canal St. Martin is the perfect place for a stroll



THE BOSS WANTS TO stay in Paris for the weekend, and let's face it, she's no greenhorn. She has

already done the big sights—the Louvre, Notre Dame, Montmartre. This time, she wants to get off the tourist beat and go deeper into *la vie Parisienne*.

Start on Friday after the day's meetings are done. If your visitor is an adrenaline junkie, she'll get a blast from Pari Roller, the world's largest weekly street-skating event (pari-roller.com). Departing at 10 p.m. from near the Montparnasse train station, Pari Roller draws up to 15,000 participants—teens to seniors—for a vigorous, three-hour dash through blocked-off Paris boulevards. To rent blades, contact Ootini Roller Proshop (ootini.com).

If this sounds a bit too active, consider a quiet dinner at the terrific, moderately priced Grizzli Café at 7 rue St. Martin in the 4th arrondissement (tel.: 01 48 87 77 56). It's cozy and friendly, with creative interpretations of classic dishes. Don't miss the *moelleux*, warm chocolate cake with a molten center.

Saturday morning, it's off to the Right Bank's little-visited 10th arrondissement

A Parisian's Paris

Lesser-known spots and eateries replete with local color but easy on the budget. **BY ANDY REINHARDT**

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The Government of Israel
through the Government Companies Authority

hereby gives notice that it is considering sale of the holdings of the State of Israel
by way of a private sale in

"Bezeq" the Israel Telecommunication corp. Limited.
("the Company"), (SC/52003193-1)

The holdings of the State which are for sale *en bloc* by way of a private sale, consist of shares comprising 30% of the share capital of the Company ("the Shares Being Sold") and options to purchase up to an additional 10.66% of the share capital of the Company ("the Options") (the Shares Being Sold and the Options are hereinafter referred to as "the State's Holdings").

Whosoever wishes to purchase the State's Holdings (as set forth in the Sale Procedure as defined below), may apply to the Government of Israel through the Government Companies Authority ("the Authority"), in the manner described in this Notice.

The procedure for the sale of the State's Holdings and its appendices ("the Sale Procedure"), in Hebrew and in English, a copy of the decisions of the Ministerial Committee for Privatization and additional information relating to the Company, can be found on and downloaded from the Authority's website at www.gca.gov.il. In addition, a copy of the Sale Procedure and its appendices can be obtained at the Privatization Unit of the Government Companies Authority, The Prime Minister's Office, 3 Kaplan Street, Jerusalem, on the 8th floor, Room 808. Tel: +972-2-6707153/4/5; Fax: +972-2-5665821, Sunday to Thursday, 10:00 – 18:00, starting on August 29, 2004.*

The Sale Procedure is available in Hebrew and in English. The English version of the Sale Procedure is for convenience only.

Merrill Lynch International acts as advisor to the Authority in the sale process.

The date for submitting applications pursuant to the terms set out in the Sale Procedure, is October 28, 2004, between 10:00 and 18:00,* at the Authority's offices at 17 Kaplan Street in Tel Aviv (the Jewish Agency building), 7th floor.

The Authority may, at any time, by giving appropriate notice, postpone or bring forward the date for submitting applications, and it may change dates and other terms in the Sale Procedure, all at its absolute discretion. Notices concerning changes in the Sale Procedure, setting dates and various updates, will be published on the Authority's website or in a daily newspaper or by written notice to participants in the sale proceeding.

The sale of the State's Holdings is exempt from tender under the Duty to Tender Regulations, 5753-1993.

It is hereby clarified that this notice is not an invitation to the public to purchase the State's Holdings, nor is it an offer and/or undertaking on the part of the Government of Israel to sell the State's Holdings, including to the applicant who makes the highest offer or to any offeror. Selection of the Buyer will be made in accordance with the Sale Procedure, including on the basis of possible negotiations, at the discretion of the State's Representatives. The State's Representatives are authorized, at their full and absolute discretion, to negotiate with whoever they see fit, if anyone.

The State reserves the right to change the terms of the sale proceeding, to suspend it or terminate it, at any time, if it sees fit to do so, without publication of further notice.

Purchase of the State's Holdings is subject, inter alia, to the consent of the Antitrust Commissioner and to the approval of the Prime Minister and the Minister of Communications pursuant to the Communications Law (Telecommunications and broadcasts), 5742-1982 and to the Telecommunications Order (Determination of essential service provided by Bezeq, The Israel Telecommunication Corp. Ltd.), 5757-1997.

*Arrival to the Authority's offices must be coordinated by calling the above-mentioned telephone numbers, at least 24 hours in advance.

for a stroll along the tree-lined Canal St. Martin. The prettiest section runs north from Rue du Faubourg du Temple near the Place de la République. If it's raining, head for a small museum. Two obscure gems: the Musée Jacquemart-André (158 blvd. Haussmann, 75008), a private collection of Renaissance and 18th century French paintings with a great café; and the Musée des Arts et Métiers (60 rue Réaumur, 75003), which chronicles the history of technology.

For dinner, a Belle Epoque classic: Brasserie Bofinger, 5 rue de la Bastille in the 4th arrondissement (01 42 72 87 82). In a roomy nonsmoking section under a stained-glass dome, diners can feast on oysters, *choucroute garni*, and apple tart, washed down with a nice Alsatian wine, for less than \$40 each.

On Sunday morning the locals sleep late. That's a good time for a peaceful walk along the Seine or in the Tuileries gardens. Then, the boss can get in line for

Paris' newest rage, *le brunch*, at Le Pair Quotidien, 18 rue des Archives in the historic Marais district. If the crowds or the \$22 per person tab are turn-offs, she could saunter to L'As du Falafel, 34 rue des Rosiers, and sample a tasty falafel sandwich for about \$6. When she has had her fill, she has plenty of time to catch an afternoon flight. She could even skip a cab and take the \$10 RER commuter rail train to the airport. That should make her feel like a real Parisian. ■

Exploring Tokyo on Foot

And at the end, stop in for a blessed massage. **BY CHESTER DAWSON**



FREQUENT VISITORS to Tokyo know the routine: Sushi breakfast at the world's largest fish market,

followed by window shopping at tony Ginza boutiques, and then a dinner boat cruise on the Sumida River. But for the savvy traveler who has been there, done that, Tokyo offers hidden charms to rejuvenate the heart and relieve the soles.

Start the day with "morning service"—or continental breakfast—at any of the thousands of tiny coffee shops near major subway entrances. Take a seat next to bleary-eyed workers and lay 350 yen (\$3.18) on the counter. That will buy a piping hot slice of inch-thick toast, boiled egg, and cup of coffee, made to order, from a strainer filled with freshly ground beans. Work off the carbs by threading through the morning throng of commuters toward one of Japan's high-tech emporiums in Shinjuku or Shibuya, such as Bic Camera or Yodobashi. These electronic department stores offer the latest gadgets—some sold only in Japan.

After the blaring sights and sounds of *Blade Runner*-style Japan, make for the tranquility of one of central Tokyo's few urban oases: Shinjuku Gyoen or Hamarikyu Gardens. Both parks are only a short walk from major hubs. Buy a *bento* boxed lunch at the Shinjuku Isetan or Mitsukoshi department stores on the way and then spread out on Shinjuku Gyoen's lush lawn or in the shade of its cherry trees. Hamarikyu, a hidden



FOOD FLOOR Buy a *bento* box at a department store

hangout on the far side of Ginza originally built to house a feudal lord in the 1600s, still contains two duck-hunting grounds. Don't miss the *macha* green tea and dessert combo for 500 yen (\$4.55) served in the traditional tea house located on an island in a pond across a short bridge.

Tokyo is nothing if not pedestrian-friendly with sidewalks, short cuts, and underground passages galore. That's a good thing since taxi fares start at 660 yen (\$6.00) just for climbing into the back seat. But all that walking around

takes its toll on one's feet. Stop in at one of the city's ubiquitous foot-massage parlors. Queensway, a chain of reflexology salons, offers a 25-minute foot bath and massage session for 2,625 yen (\$23.86).

Dinner in Tokyo can range from five-star French to a bowl of *ramen* noodles served from a street cart. One newer A-list restaurant is Gonpachi in trendy Nishi-Azabu. Built like a feudal keep, diners peer down at the open kitchen from tables lining the walls. Try the skewered shiitake mushrooms stuffed with minced chicken or handmade buckwheat noodles. Expect to spend about \$50 a person, not including the hot cups of sake. ■



9-11am:

Have brunch with editor for upcoming
article on next year's Spring/Summer collection

1pm-3pm:

Drop by designers luncheon to discuss
tomorrow's charity fashion show

4pm-6pm:

Prepare a surprise candlelight dinner for two
to celebrate husband's birthday

or

3pm-5pm: Watch 2005 Paris
Summer Collection on TV in
preparation for next week's article)

Life's

EDITED BY TODDI GUTNER

SURVEYS

THESE TEENS HAVE A LOT TO TELL THE POLS

AMERICA'S TEENAGERS have strong opinions about personal finance matters. They are intricately involved in their household buying decisions. And with 35% collecting an allowance—more than half receiving up to \$20 a week—some are even learning the value of money. So says a **Junior Achievement and Allstate Foundation** poll of nearly 1,000 13- to 18-year-olds. Taxes are a big issue: 74% of the girls and 66% of the boys think they're excessive. With views like these, this group could make a formidable voting block when they all come of age in the next five years.

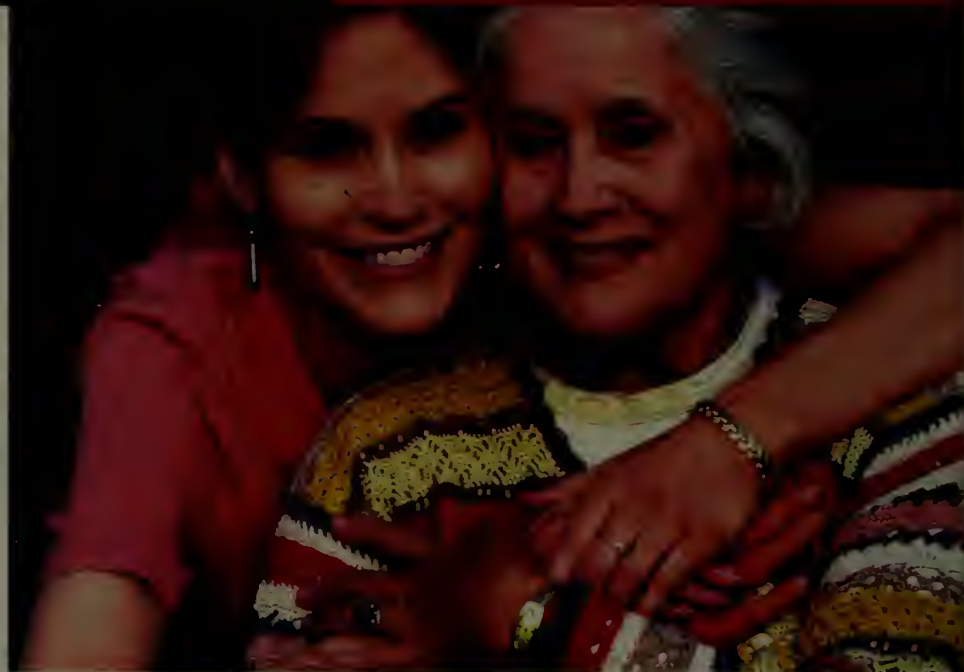
Among teenagers 13 to 18...

13%	HAVE THEIR OWN CREDIT CARDS
16%	OWN STOCK
49%	BELIEVE SOCIAL SECURITY WILL NOT BE AVAILABLE WHEN THEY REACH 65
70%	THINK TAXES ARE TOO HIGH
68%	SAY THEY INFLUENCE HOUSEHOLD BUYING DECISIONS
35%	RECEIVE ALLOWANCE, FOR WHICH 74% OF THEM WORK

Data: Junior Achievement, Allstate Foundation

TIME OFF

Color will reign in the Berkshire mountains of western Massachusetts this fall. In addition to the usual reds, oranges, and golds of the changing leaves, you can see an exhibit at the **Berkshire Museum** in Pittsfield featuring brilliantly colored illuminated works by 20 contemporary U.S. artists. In their creations, some of which are interactive, the artists integrate light through the use of shadows, illusions, glowing jewels, candlelight conjuring up spirits, twilight, and other luminous effects. Presence of Light will be on view through Oct. 31 (berkshiremuseum.org).



TAXES

The Parent Credit

LOOKING FOR A WAY to cut your federal income taxes, short of having another child? If you've been supplying more than half the support for a parent, you might be eligible to take an extra dependent exemption of \$3,100 in 2004. Even if you kick in less than 50%, as long as family members together contribute more than half, you can get the exemption if other contributors agree in writing not to claim it, says Mark Luscombe, a CPA and tax lawyer with **CCH Tax & Accounting**.

You're entitled to a dependent child-care credit of up to \$3,000 as well if you hire someone to watch over mom or dad while you work. Or you might be able to add such an expense to other health costs you pay to top the 7.5% adjusted gross income hurdle to write off medical expenses. For single people, there's the added benefit of becoming a "head of household," possibly lowering your tax bracket. Remember, your parent must earn less than \$3,100 in taxable gross income. For details, go to irs.gov and check out Publication 501.

—Carol Marie Cropper



GADGETS

A MIGHTIER BALLPOINT

IT'S A PEN. No, it's a highlighter. Well, it's actually both. The new **Sheaffer Prelude MPI** conveniently converts from one to the other when you twist the barrel. Handy for marking up documents, it comes in three styles with 22K gold plate trim, for \$45, \$60, and \$70, depending on the finish. A new ballpoint pen cartridge costs \$2.25, and a three-pack of highlighter refills goes for \$7.50 (sheaffer.com).

(4:30pm: It looks like the 'Earthy Green look' will be back, as you start making the lobster salad)

Good

With its built-in LCD TV, the LG TV refrigerator allows you to get more things done in the kitchen than just the cooking.

It's just one way LG makes life good.
To see more ways, visit www.lge.com



Life's Good



LG



BY ROBERT BARKER

This IPO Flunks the Close Scrutiny Test

Whatever its ultimate merits, the federal No Child Left Behind Act education reform has already achieved what I had imagined to be impossible: It has expanded the universe of anxieties plaguing parents. The NCLB promotes "high-stakes" tests—the sort that if kids fail, they may get to spend a second year in third grade or to exit high school without a diploma.

To give their kids a boost, more parents are paying for tutors. That's a reason such test prep outfits as Princeton Review saw sales in its elementary- and secondary-school segment soar by 72%.

Now here comes Educate, the Baltimore parent of the nation's leading tutoring chain, Sylvan Learning Centers, with 1,039 outposts in North America. Led by Goldman Sachs, Educate aims soon to sell stock in an initial public offering estimated at \$225 million. Given Sylvan's good reputation and the fast growth in supplemental educational services—more of them now sold to public schools and funded by the feds—you might be tempted to ask your broker for shares. My advice: Don't. I say that not because Educate isn't growing. First-half revenue rose 33%, to \$169 million. But when you think about Educate, don't forget your ABCs.

As in Audit Committee. In many IPOs, selling stockholders don't give up control. They aren't in this case, either, as Educate's chief owner, private equity firm Apollo Advisors, plans to keep 53%. An example of this control is Educate's decision to wait up to a year to comply with a rule that only independent directors serve on the board's audit committee. Instead the panel will be headed temporarily by an Apollo principal until the board finds the right outsider. Kevin Shaffer, Educate's chief financial officer, said this is a "critical position," so the board is conducting a thorough search. He hopes it will be done within six months.

Bas in Balance Sheet. Of the 15 million shares set to go in the IPO at an estimated \$15 each, 10 million are being dumped by current owners, principally Apollo. None of the proceeds will go to Educate, which figures to net just \$67.5 million. All of that



is going to repay some of the debt the company took on when Apollo acquired it. Educate owes this money to a syndicate of lenders, including three of the IPO's top underwriters, J.P. Morgan Chase, Merrill Lynch, and Bank of America. Assuming all goes as planned, Educate still will owe long-term debt of \$106 million—all of it at variable interest rates. Some of that risk is hedged via interest-rate swaps. But as its registration statement notes, if rates go up, "our interest expense would increase, our ability to borrow additional funds may be reduced, and the risks related to our substantial indebtedness would intensify."

GOOD LESSON? The money raised will go to pay back some of Educate's debt

Cas in Cost. The IPO is set to value Educate at some \$790 million. That is, \$639 million in equity value, plus the \$152 million in net debt now on its books. Is that reasonable? We have a couple of points of comparison. The first is Princeton Review, which has no net debt. The market values its equity near \$195 million, or 1.7 times revenue over the past four quarters. Educate is set to sell its stock at 2.8 times trailing revenue. Next we can look at what Apollo paid for Sylvan's operations, which form the bulk of what is now Educate. Apollo's purchase closed in June, 2003, at a price of \$283 million. That was 1.3 times the prior year's revenues. Shaffer notes that Sylvan is now refocused on better opportunities, such as NCLB.

Put it together, and what all this spells to me is a test of how to make money on Wall Street. But only the sellers will pass. ■

E-mail: rb@businessweek.com

Studying Educate

Revenue	\$283.9
Operating income	31.2
Net income	8.5
Net debt	152.3
Indicated market cap	638.6
Tentative symbol	EEEE

Data, in millions, for 12 months ended June 30; net income is from continuing operations
Data: Company reports



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BY GENE G. MARCIAL

A STRONG AEROSPACE UPDRAFT IS LIFTING ROCKWELL COLLINS.

WHY FORD AND GM NOW USE BEI TECHNOLOGIES' STABILIZERS.

MOBIUS IS A RISING STAR IN STORING DIGITIZED DOCUMENTS.

All Signals Go at Collins

TECHS AREN'T FLYING off the charts, but Rockwell Collins (COL) is, hitting a new high of 35, up from 29 in May. Spun off in 2001 by Rockwell International, Collins is a world leader in high-tech aviation electronics and communications. "The aerospace market is on the way to a global recovery, and defense spending is apt to stay robust—a big plus for Collins," says Marion Schultheis of investment firm J. & W. Seligman, which owns shares. Among big Collins investors: Barclays Bank, T. Rowe Price, and Warren Buffett's Berkshire Hathaway. Defense accounted for 50% of Collins' sales in 2003, and commercial 50%. Schultheis says rising demand for business jets and larger aircraft is boosting commercial sales. She notes that Collins has been selected for a group led by General Dynamics to develop small, lightweight, software-oriented radios for all branches of the U.S. military. Cai von Rumohr of investment firm SG Cowen sees Collins earning \$1.66 a share in 2004 ending Sept. 30, and \$1.93 in 2005—both above consensus estimates. Some "wild cards" not reflected in his numbers, says von Rumohr, are the improving demand for widebody aircraft in Asia and a possible recovery in the ailing U.S. airlines.



These Chips May Keep SUVs From Rolling Over

LITTLE-KNOWN BEI Technologies (BEIQ) is catching the eye of investors: Its GyroChips may be part of the solution for sport-utility vehicles that roll over. The GyroChip, first used in military aircraft, powers electronic sensors that detect when a vehicle begins to tilt. It rights the vehicle by automatically slowing the engine and activating the antilock brakes. Germany's Continental Teves is BEI's largest customer, supplying Ford Motor. On July 23, Ford announced it would install stability-rollover systems in the Explorer and three other SUV models. Ford has been sued over Explorer rollover accidents. General Motors also uses the BEI systems. "Demand for the chip has grown so fast that BEI has had to ramp up production," says Steve Cohen, a partner at investment firm Kellner DiLeo Cohen, which owns shares. That has caused BEI stock to leap up—from 20 in May to 25.

Cohen sees BEI hitting 36 in a year, based on his earnings forecast of 87¢ a share in 2004 ending Sept. 30, \$1.35 in 2005, and \$1.60 in 2006, way up from 39¢ in 2003. Demand for stability-rollover control product is gaining momentum, says Michael Harris of investment firm Robert W. Baird. BEI says it will ship 3.7 million GyroChip units by the end of fiscal 2004. Its forecast is to ship 5.5 million in 2006.

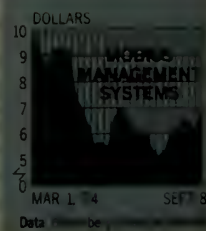
GROWTH IS ON A ROLL



Is IBM Eyeing Mobius?

ABOUT 90% OF CUSTOMERS at Mobius Management Systems (MOBI) are the bluest of blue chips: Citigroup, Bank of America, J.P. Morgan Chase, Abbott Labs, and Britain's Defense Ministry. Yet no major Street analyst covers the company, which hasn't helped Mobius shares—down from 10 in March to 6.95. Goldman Sachs took it public in 1998 at 14. Some hedge funds have snapped up shares but declined to be quoted. They see Mobius as a takeover target. It has a 70% share of a niche market: It provides software to help companies organize, store, call up, and manipulate digitized documents. Mobius' rival, Documentum, was acquired by storage giant EMC in 2003. IBM also made a bid for Documentum but failed. So some pros expect IBM to make a run for Mobius. A money manager whose outfit owns 5% of the stock says that on fundamentals alone, Mobius is worth 15. For fiscal 2005 ending June 30, another money pro, who is also buying, expects Mobius to exceed its 2004 results: earnings of \$4.8 million, or 24¢ a share, on record sales of \$88.1 million. He says Mobius has an estimated cash hoard of \$65 million, or nearly \$4 a share, with no debt. IBM declined comment. Mobius did not return calls. ■

A TIME TO BUY LOW



BusinessWeek online Gene Marcial's Inside Wall Street is posted at businessweek.com/today.htm at 5 p.m. EST on the magazine's publication day, usually Thursdays. See Gene on Fridays at 1:20 p.m. EST on CNNfn's *The Money Gang*.

Note: Unless otherwise noted, neither the sources cited in Inside Wall Street nor their firms hold positions in the stocks under discussion. Similarly, they have no investment banking or other financial relationships with them.



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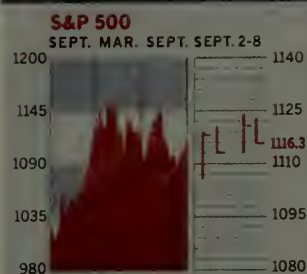
You should consider the investment objectives, risks, charges and expenses of a mutual fund carefully before investing. The fund's prospectus contains this and other important information. For a current prospectus, please visit etrade.funds.etrade.com. Read the prospectus carefully before investing.

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Personal Business Figures of the Week

STOCKS

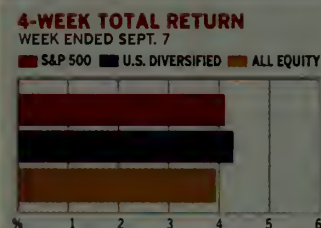


COMMENTARY

Investors returned from the Labor Day weekend in a buying mood, sending markets higher. Although on Sept. 8 stocks backed off from their gains, they stayed in positive territory for the week. Leading the way were the Dow Jones industrials, which rose 1.4%, followed by the S&P 500, which added 0.9%. But the NASDAQ Composite was flat, as investors shied away from tech.

Data: Bloomberg Financial Markets, Reuters

MUTUAL FUNDS



Data: Standard & Poor's

U.S. MARKETS

	SEPT. 8	WEEK	% CHANGE YEAR TO DATE	LAST 12 MONTHS
S&P 500	1116.3	0.9	0.4	8.2
Dow Jones Industrials	10,313.4	1.4	-1.3	7.6
NASDAQ Composite	1850.6	0.0	-7.6	-2.0
S&P MidCap 400	582.5	0.2	1.1	10.0
S&P SmallCap 600	283.3	1.2	4.7	13.0
DJ Wilshire 5000	10,860.3	0.9	0.6	8.5

SECTORS

			% CHANGE YEAR TO DATE	LAST 12 MONTHS
BusinessWeek 50*	642.8	1.1	3.3	9.1
BW Info Tech 100**	321.8	-0.5	-8.2	-1.7
S&P/BARRA Growth	543.8	0.8	-2.2	3.6
S&P/BARRA Value	568.3	1.0	3.0	12.9
S&P Energy	261.8	1.1	16.8	28.4
S&P Financials	390.9	1.5	2.9	13.1
S&P REIT	130.3	1.9	14.8	21.3
S&P Transportation	205.2	1.6	1.6	13.7
S&P Utilities	126.6	-0.2	6.9	15.7
GSTI Internet	138.9	1.2	-4.0	-0.5
PSE Technology	654.4	-0.2	-6.2	-0.4

*Mar. 19, 1999=1000 **Feb. 7, 2000=1000

GLOBAL MARKETS

	SEPT. 8	WEEK	% CHANGE YEAR TO DATE	LAST 12 MONTHS
S&P Euro Plus (U.S. Dollar)	1165.0	1.5	-1.2	15.8
London (FT-SE 100)	4558.4	1.3	1.8	6.2
Paris (CAC 40)	3677.6	1.8	3.4	7.9
Frankfurt (DAX)	3884.2	1.7	-2.0	6.7
Tokyo (NIKKEI 225)	11,279.2	1.4	5.6	5.6
Hong Kong (Hang Seng)	13,050.0	0.2	3.8	16.9
Toronto (S&P/TSX Composite)	8354.8	-0.7	1.6	9.4
Mexico City (IPC)	10,538.0	2.0	19.8	34.8

FUNDAMENTALS

	SEPT. 7	WEEK AGO	YEAR AGO
S&P 500 Dividend Yield	1.70%	1.72%	1.62%
S&P 500 P/E Ratio (Trailing 12 mos.)	19.8	19.5	28.7
S&P 500 P/E Ratio (Next 12 mos.)*	16.3	16.2	16.7
First Call Earnings Revision*	-0.04%	-2.66%	0.46%

*First Call Corp.

TECHNICAL INDICATORS

	SEPT. 7	WEEK AGO	READING
S&P 500 200-day average	1113.1	1111.7	Positive
Stocks above 200-day average	58.0%	52.0%	Neutral
Options: Put/call ratio	0.80	0.73	Positive
Insiders: Vickers NYSE Sell/buy ratio	3.22	3.05	Negative

BEST-PERFORMING GROUPS

	LAST MONTH %		LAST 12 MONTHS %
Internet Retail	20.8	Steel	76.1
Internet Software	16.5	Internet Software	70.8
Divsfd. Metals & Mining	15.2	Internet Retail	70.3
Home Improvement Stores	12.7	Oil & Gas Refining	59.3
Oil & Gas Drilling	12.7	Homebuilding	51.6

WORST-PERFORMING GROUPS

	LAST MONTH %		LAST 12 MONTHS %
Semiconductors	-11.2	Semiconductor Equip.	-32.6
Semiconductor Equip.	-4.4	Semiconductors	-28.6
Instrumentation	-3.5	IT Consulting	-26.7
Advertising	-2.3	Airlines	-26.5
Food Wholesalers	-1.6	Electric Mfg. Svcs.	-22.2

EQUITY FUND CATEGORIES

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		LEADERS	
Real Estate	7.8	Natural Resources	32.0
Health	7.3	Latin America	30.1
Latin America	6.0	Real Estate	28.9
Financial	5.9	Europe	21.9
LAGGARDS		LAGGARDS	
Technology	1.2	Technology	-9.8
International Hybrid	2.3	Precious Metals	-0.2
Domestic Hybrid	2.5	Small-cap Growth	1.5
Europe	2.5	Mid-cap Growth	3.4

EQUITY FUNDS

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		LEADERS	
Franklin Biotech. Dscvy. A	14.3	iShares MSCI Austria Idx.	58.1
ProFds. Biotech. Utr. Inv.	14.2	Bruce	53.0
Scudder Glob. Biotech. A	13.6	ProFds. Wrldss. Ultsr. Inv.	52.6
Morgan Stanley Biotech. B	12.9	State St. Rsch. Gl. Rs. B	50.3
LAGGARDS		LAGGARDS	
GMO Asia III	-46.3	ProFds. Smicdr. Ultsr. Inv.	-44.3
ProFds. Smicdr. Ultsr. Inv.	-14.4	GMO Asia III	-36.1
ProFds. Ush. Sm. Cap Inv.	-12.2	Rydex Electronics Inv	-33.7
ProFds. Ush. Mid Cap Inv.	-9.5	Ameritor Investment	-32.4

INTEREST RATES

KEY RATES

	SEPT. 8	WEEK AGO	YEAR AGO
Money Market Funds	1.04%	1.04%	1.04%
90-Day Treasury Bills	1.64	1.58	0.94
2-Year Treasury Notes	2.47	2.47	1.81
10-Year Treasury Notes	4.16	4.12	4.27
30-Year Treasury Bonds	4.80	4.80	4.80
30-Year Fixed Mortgage †	5.80	5.69	6.43

†BancQuote, Inc.

BLOOMBERG MUNI YIELD EQUIVALENTS

Taxable equivalent yields on AAA-rated, tax-exempt municipal bonds, assuming a 30% federal tax rate.

	10-YR BOND	30-YR BOND
General Obligations	3.70	4.10
Taxable Equivalent	5.14	6.57
Insured Revenue Bonds	3.70	4.10
Taxable Equivalent	5.37	7.01

THE WEEK AHEAD

RETAIL SALES Tuesday, Sept. 14, 8:30 a.m. EDT » August retail sales were probably flat, after a 0.7% increase in July. That's based on the median forecast of economists surveyed by Action Economics. Excluding autos, sales most likely improved by 0.3%, after a 0.2% rise in July.
CURRENT ACCOUNT Tuesday, Sept. 14, 8:30 a.m. EDT » The U.S. current account deficit is forecast to have widened to a

record \$162.5 billion in the second quarter, after growing to \$144.9 billion in the first.
BUSINESS INVENTORIES Wednesday, Sept. 15, 8:30 a.m. EDT » July inventories probably increased by 0.6%, following a 0.9% rise in the prior month.
INDUSTRIAL PRODUCTION Wednesday, Sept. 15, 9:15 a.m. EDT » Industrial output is expected to have picked up by

0.5% during August, after a gain of 0.4% in July. The average operating rate most likely moved up to 77.3%, from 77.1% in July.
CONSUMER PRICE INDEX Thursday, Sept. 16, 8:30 a.m. EDT » Consumer prices for goods and services probably moved up 0.3% in August, after edging down 0.1% in July. Excluding food and energy, prices likely moved up by 0.2%, following a 0.1% gain in July.

The BusinessWeek production index climbed to 225.8 for the week ended Aug. 28, an increase of 13.4% from the previous year. Before calculation of the four-week moving average, the index rose to 228.2.

BusinessWeek online

For the BW50, more investment data, and the components of the production index visit www.businessweek.com/magazine/extra.htm

Time Zone Tim might be sleep deprived,
but he's never network deprived.

NAME: Time Zone Tim

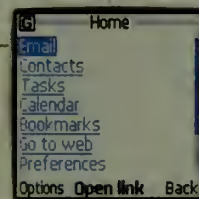
QUOTE: "Zzzzzzzzzzzzzz."

CHALLENGE: Always traveling, yet always needs real-time access to critical corporate data, email, and more. Also needs to stay awake.

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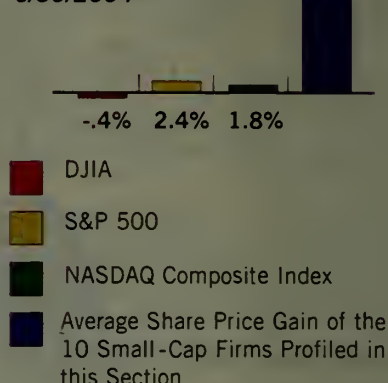
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THE EQUITY INVESTOR'S 26-WEEK SMALL-CAP REVIEW

SELECTED PROFILES OF THE NATION'S TOP PRICE-PERFORMING SMALL-CAP COMPANIES AS OF 6/30/04

From approximately 1,700 domestic companies with market capitalizations of 200 million to one billion dollars, the following pages highlight selected top-ranking firms, in terms of share price performance for the 26-week period ending 6/30/04. Each profile describes a leading company including its industry, market trends and reasons for success, as written by company management. And while past performance is never a guarantee of future results, these top-performing companies represent investment opportunities worthy of a small-cap investor's close consideration.

Gain/Loss for the
26-Week Period Ending 6/30/2004



Inland Real Estate Corporation • IRC • Real Estate

Oak Brook, IL • IR Contact: Trista Hertz • 630-218-7364
hertz@inlandrealestate.com • www.inlandrealestate.com



This company is a self-administered and self-managed real estate investment trust based in Oak Brook, Illinois. The company focuses on owning, acquiring and managing neighborhood and community retail centers located primarily in the Midwestern United States, with concentrated property portfolios in Chicago and Minneapolis. Its properties consist of grocery-anchored, discount-anchored, fashion-anchored and convenience retail centers, as well as free-standing single-tenant properties. The company currently owns and manages 139 retail properties in eight states, with more than 12 million square feet of real estate and more than \$1.2 billion in assets.

Key Manager Statement

"Inland Real Estate Corporation has been in existence for 10 years and in that time we have grown our asset base and our income, and have provided strong returns to our investors with eleven dividend increases, leading to our current annual dividend of \$0.94 per share, which we pay monthly."

Mark E. Zalatoris, COO, Executive Vice President, Treasurer

Stanley Furniture Company, Inc. • STLY • Furnishings

Stanleytown, VA • IR Contact: Doug Payne • 276-627-2000
www.stanleyfurniture.com



Celebrating its 80th Anniversary, Stanley Furniture Company, Inc. is a leading designer and manufacturer of fine quality, residential wood furniture in designs ranging from traditional to contemporary. Stanley Collections are presented as dining room, bedroom, home entertainment, accent tables and home office. Young America® is built to grow with the child from crib to college and beyond.

Presented the Pinnacle Award—the industry's highest design honor—nine times, Stanley's focus is on creating exciting designs, producing quality products and providing excellent service. The company's blended operating strategy combines efficient domestic manufacturing in highly focused facilities with intelligent outsourcing of certain component parts and finished goods. The resulting competitive advantage is the ability to offer a compelling value proposition based on higher value and well-styled product without sacrificing their culture of high quality and quick delivery, which is among the best in the industry. Stanley's multi-channel distribution strategy includes independent furniture stores, regional chains, department stores, designers and international accounts.

Independence Holding Company • IHC • Insurance

New York, NY • IR Contact: David T. Kettig • 212-355-4141 x3047
www.independenceholding.com



Independence Holding Company, which was recently listed on the New York Stock Exchange, is a life and health insurance holding company. Primarily through its captive distribution system, IHC is a leading national writer of excess health insurance for self-insured employer group medical plans. IHC also sells niche group life, health, short-term and long-term disability products and acquires blocks of policies. A portion of IHC's business is ceded to its 40% owned affiliate, American Independence Corp. (NASDAQ: AMIC). AMIC utilizes federal net operating loss carryforwards of over \$287 million to eliminate the major portion of its federal income taxes.

Key Manager Statement

"IHC has a strong balance sheet with assets of approximately \$1 billion, and stockholders' equity of \$171 million. We are very proud that IHC's stock price has grown at a 30% compound annual rate since September 1991, and IHC has posted net income in 45 consecutive quarters. We are optimistic that IHC can continue to enhance its business and shareholder value."

Roy T.K. Thung, President & CEO

Resource America, Inc. • REXI • Specialty Finance

Philadelphia, PA • IR Contact: Pam Schreiber • 215-546-5005
www.resourceamerica.com



Resource America Inc. (RAI) is a specialized asset management company that uses industry specific expertise to generate and administer investment opportunities for its own account and for outside investors in the financial services, energy, real estate and equipment leasing industries. As a specialized asset manager, RAI develops proprietary investments, originates the underlying assets, invests for its own account and raises investment dollars from high net worth individuals and institutions. For its continuing role in management of its programs, RAI typically receives administrative fees for managing investor's funds, a carried interest in the profits of the program and asset management fees for management of underlying assets.

Key Manager Statement

"With the increase in interest in the areas in which we specialize, RAI has capitalized on its reputation for delivering favorable returns anticipated by its investors. Assets under management have grown accordingly. As an investor and a manager RAI benefits from the increase in value of the underlying assets resulting from the excellence of its investment programs."

Jonathan Z. Cohen, CEO

THE EQUITY INVESTOR'S 26-WEEK SMALL-CAP REVIEW

JoS. A. Bank Clothiers, Inc. • JOSB • Menswear Retailing

Lampstead, MD • IR Contact: David E. Ullman, EVP-CFO • 410-239-5715
www.josbank.com



JoS. A. Bank Clothiers (Nasdaq/NMS: JOSB) is a leading designer and retailer of men's classically-styled tailored and casual clothing, sportswear, and accessories. The Company sells its full product line through more than 230

mail stores in 36 states, a nationwide catalog, and the Internet at www.josbank.com.

JOSB has set the standard for superior quality in men's apparel and has significantly enhanced the recognition of the JoS. A. Bank brand. The success of its strategy has allowed JOSB to post impressive sales growth and a compound net income growth rate of approximately 75% annually from 1999 through the current year (fiscal 2004). Management has provided guidance that net income should increase at least 40% in fiscal 2004.

Key Manager Statement

"We will continue to grow our sales and profits as we more than double the current store base by expanding to approximately 500 stores by 2007. Our ultimate objectives are to (1) become the dominant menswear brand in the U.S., (2) generate superior growth in sales and profits, and (3) evolve into a global consumer products company."

Robert N. Wildrick, CEO

Berry Petroleum Company • BRY • Oil & Gas Production

Bakersfield, CA • IR Contact: Todd Crabtree • 661-616-3832
www.bry.com



Berry Petroleum Company (NYSE:BRY) is engaged in the production, exploitation and exploration of crude oil and natural gas. Berry's principal reserves (110 million barrels at 12/31/03) and producing properties are located in central California and northeastern Utah.

An aggressive drilling program is resulting in nearly a three-fold increase in daily production to 4,500 BOEPD on a 44,000 acre 2003 acquisition in Utah's Uinta Basin. Berry also acquired an interest in an additional 175,000 acres in that basin, targeting shallow light oil and deep natural gas. Capital expenditures should total \$60 million in 2004, while targeting a 24% increase in company-wide production over 2003.

Key Manager Statement

"Berry is making acquisitions, growing, and setting production and financial records along the way. We have a very strong balance sheet, financial flexibility, and we're disciplined about the acquisitions that we make. Our growth story, our excellent financial results and our dividend make us a very attractive investment."

**Robert F. Heinemann
President & CEO**

Ptek Holdings, Inc. • PTEK • Business Comm. Svcs.

Atlanta, GA • IR Contact: Sean O'Brien • 404-262-8462
www.ptek.com



Founded in 1991, Ptek Holdings, Inc. is a leading provider of business communications services, including audio and Web conferencing and high-volume data processing and delivery. Global enterprises use the Company's secure and reliable platform to communicate with partners and constituents, and to automate their daily business processes. The cost-effective solutions Ptek provides include all forms of group collaboration, electronic statements and invoices, confirmations of securities trades and travel arrangements, logistics support and document management, such as the conversion of fax messages to e-mail. The Company's global sales force of more than 800 professionals in 18 countries, provides services to more than 32,000 companies in almost every business sector.

Key Manager Statement

"By continually innovating new solutions that simplify our customers' critical day-to-day business processes, we position our Company as a more valuable business communications services provider."

Boland T. Jones, Chairman & CEO

RAE Systems Inc. • RAE • Homeland Security

Sunnyvale, CA • IR Contact: Lea-Anne Matsuoka • 408-585-3567
www.raesystems.com



RAE Systems is a leading global developer of rapidly deployable radiation and multi-sensor chemical detection networks and monitors. RAE Systems' solutions are used for homeland defense and public venue security by many U.S. Government agencies, including the Department of Homeland Security, the Department of Justice, the Department of State, all branches of the U.S. military, and by numerous city and state agencies. Our industrial markets span many of the world's leading corporations in the airline, chemical, automotive, computer and oil industries.

Key Manager Statement

"We have had nine consecutive quarters of record revenue as we continue to expand globally and innovate cutting-edge sensing and network technologies. From public venue protection to supply chain monitoring and indoor air security, RAE Systems' wireless and fixed sensing networks are providing the data that enables better, faster, life-saving response."

Robert I. Chen, CEO

Hypercom Corporation • HYC • Electronic Transactions

Phoenix, AZ • IR Contact: Laura Slagel • 602-504-5869
www.hypercom.com



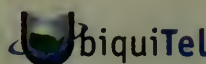
Fact: The use of debit cards is skyrocketing, particularly in the U.S. Outdated card payment terminals will be replaced to accommodate an overwhelming demand for faster transaction speeds. Multi-lane retailers are increasingly moving to signature capture and debit. By 2010, two-thirds of all transactions conducted at the point-of-sale are expected to be electronic versus cash or paper-based.

Fact: In Europe and Latin America, there is strong, escalating demand for check cards or smart card technology. China's growing economy and desire for global recognition as a top-tier economic force will escalate dramatically the need for card payment terminals and network technology. India and Russia are also moving to cards.

Fact: Hypercom (NYSE: HYC) is the only card transaction technology provider with complete, end-to-end solutions — from point-of-sale to networking. Hypercom has a strong balance sheet, a skilled top management team and a strategic plan to capitalize on a world going card crazy.

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Conshohocken, PA • IR Contact: Tayo Ogundipe, VP-Finance • 610-832-3340
www.ubiquitelpcs.com



UbiquiTel is the exclusive provider of Sprint PCS products and services under the Sprint brand name to mid-size markets

with roughly 10 million residents in portions of California, Nevada, Washington, Idaho, Wyoming, Utah, Indiana and Kentucky. UbiquiTel presently services 366,000 subscribers, or 4% of the total residents in these markets. Our strategy is to leverage our highly scalable third generation ("3G") wireless network and our relationship with Sprint along with distribution and experienced management totally focused on our midsize markets to gain market share against national competitors.

Key Manager Statement

"UbiquiTel expects to be among the fastest growing publicly traded wireless companies. In 2004, we expect to grow revenues 31% to approximately \$360 million. With 58% of our customers having purchased 3G wireless data products marketed as PCS Vision, UbiquiTel expects strong continued growth by capitalizing on Sprint and its position as a wireless data leader."

Don Harris, Chairman & CEO

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America's Stark Fiscal Choice

WHAT DO YOU WANT, entitlement reform or more tax cuts? While President Bush's soaring campaign rhetoric promises Americans that they can have it all—new and expanded tax credits for private health, savings, and retirement accounts plus big permanent tax cuts—the reality is beginning to bite. The cost of these ambitious plans, on top of committed expenditures for the new Medicare drug benefit, the war in Iraq, homeland security, agriculture, energy, highways, education, and more, will add trillions of dollars to a federal budget deficit already spinning out of control (page 36). Responsible Republicans are beginning to say that Bush must make a choice between his radical plan to change Social Security, health care, and savings programs and making his first-term tax cuts permanent. The wise choice would be to go with entitlement reform. America is facing a severe crisis as its health-care system cracks and the baby boomers approach retirement. The oldest hit 62 in just four years, and many will then begin to draw on Social Security. Three years later, in 2011, they will be eligible for Medicare. Time is running out.

The need for a choice becomes clear when the numbers are run. The latest budget estimate by the Congressional Budget Office projects deficits of \$2.3 trillion over the next 10 years. That assumes all of the tax cuts on income, estates, capital gains, and dividends passed in the first Bush term expire as scheduled. If they are made permanent, deficits surge to \$3.6 trillion through 2014. Add in the \$1 trillion to get rid of the

onerous alternative minimum tax, and the budget deficit soars close to \$5 trillion over the next decade.

These dismal figures don't include the entitlement reforms proposed by the President. Health savings accounts, perhaps his best idea, encourage companies to offer employees 401(k)-style tax advantaged accounts if they accept high deductible catastrophic health insurance.

Bush's tax cuts, plus his entitlement reform ideas, add up to deep debt

Employees can contribute up to an amount equal to the deductible (at least \$2000 for a family) with the money going to pay day-to-day doctors' bills. If it isn't spent, the money rolls over year after year. Bush is proposing to sweeten HSAs by allowing individuals to take a tax deduction for the share of the premiums they pay to buy high-deductible coverage. The self-employed who set up HSAs and buy their own catastrophic insurance

can deduct the full premium. But HSAs come with a price—lost tax revenue of up to \$30 billion over ten years. And proposals for lifetime and retirement savings accounts would cost billions of dollars in the long run.

Reforming Social Security, high on the Bush list of entitlement reforms, comes at a higher price. While there are differing opinions over how fast Social Security will run out of money, Federal Reserve Chairman Alan Greenspan believes that unless actions are taken soon to deal with Social Security and Medicare, the deficit will worsen dramatically. Bush's solution, to shift two percentage points of the 12.4% payroll tax into private retirement accounts, may benefit the young, but it would cost the Treasury \$1 trillion to \$2 trillion over 10 years, as the government pays its obligations to older retirees.

It is disingenuous of President Bush to run on this kind of fiscal folly. Add up all the promises, and you generate deficits up to \$7 trillion, \$8 trillion, or \$9 trillion over a decade—a crushing legacy for our children and grandchildren. It's time for real choices to be made.

One Nation Can't Stop the Fanatics

ANEW AGE OF BARBARISM is upon us. On the third anniversary of September 11, we witness innocent kids being murdered in a school in Russia. Women and children are being blown to pieces on buses in Israel. American, Turkish, and Nepalese workers are being beheaded in Iraq. Hundreds of Spanish commuters have been killed and hundreds more tourists murdered in Bali. While the Presidential campaigns

swirl hotly around who is the toughest leader in the fight against terrorism and what mistakes may or may not have been made in Iraq, a much larger issue remains. America, Europe, Israel, Egypt, Pakistan, and governments everywhere are under attack by Islamic extremists. These terrorists have but one demand—the destruction of modern secular society. They have but one goal—uniting Muslims under a religious caliphate that assumes control over Christians, Jews, Hindus, Buddhists, and others around the globe.

The goal of this enemy is so unbelievable, the tactics so horrible, that many hide in denial. France thought it was safe behind its anti-American foreign policy, only to have people kidnapped in Iraq in retaliation for its policy of having Muslim girls remove religious headscarves in school (page 52). It is French secular culture that Islamic fundamentalists hate.

On this anniversary of September 11, the world's leaders need to recognize that one nation alone cannot deal with the menace of radical Islam. They need to forge alliances and upgrade multilateral institutions to confront the danger ahead.

Business Week

04 September 27



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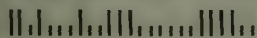
TECH'S FUTURE

The next 1 billion customers
will come from China,
India, Brazil, and other
developing nations.
The tech industry
will never be
the same.

BY STEVE NANN (P. 82)



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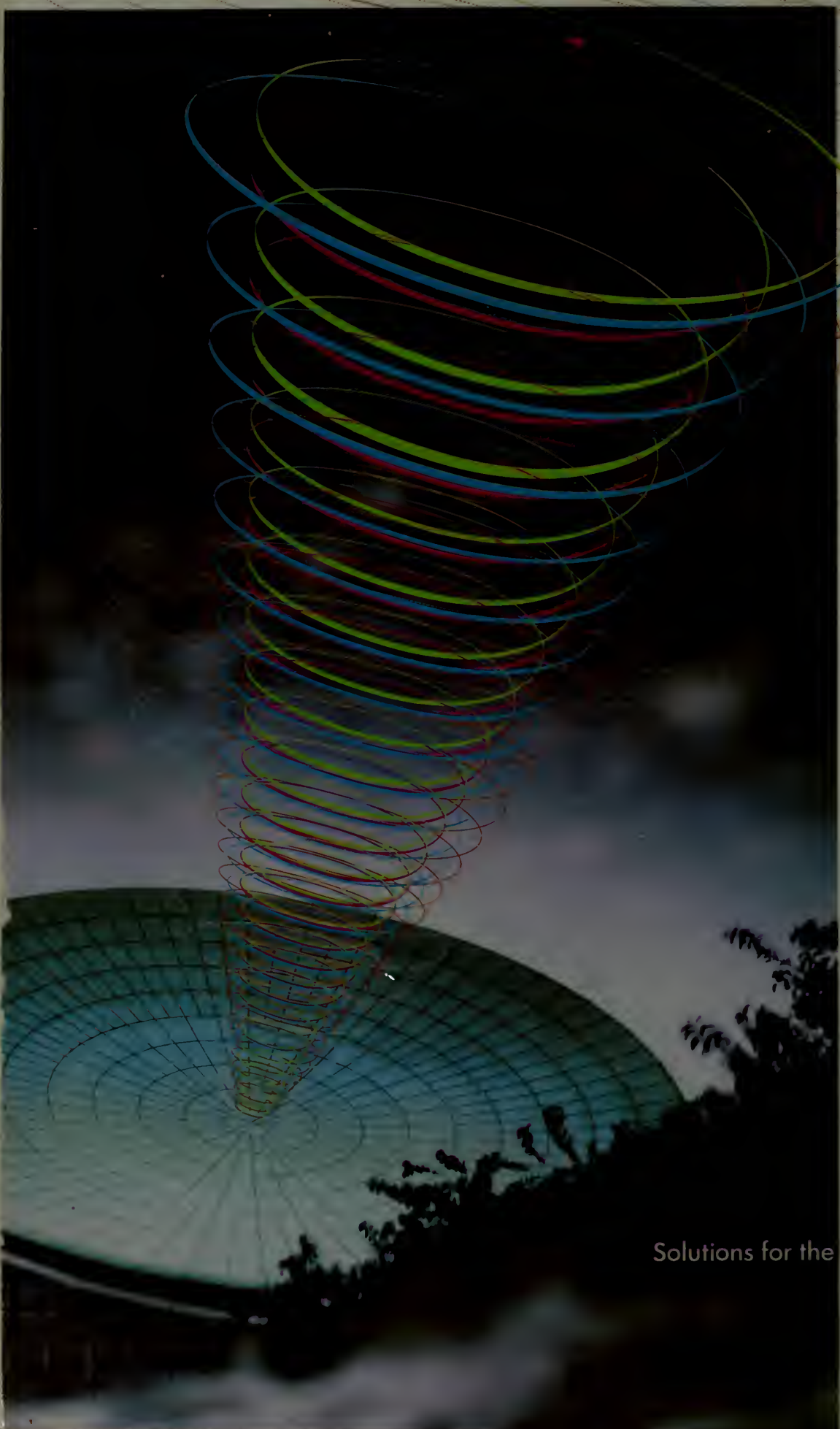


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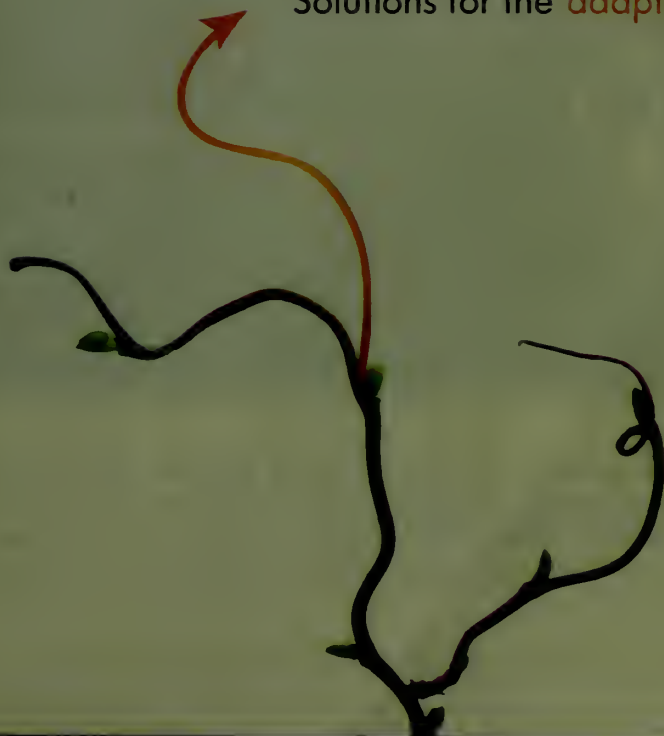
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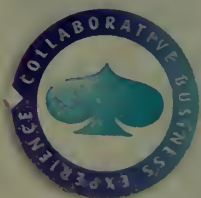
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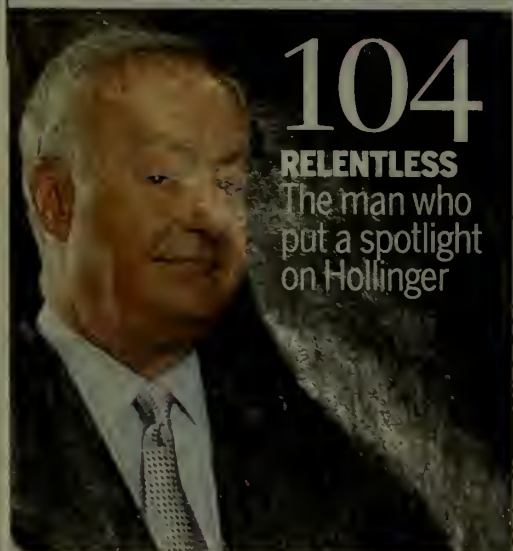
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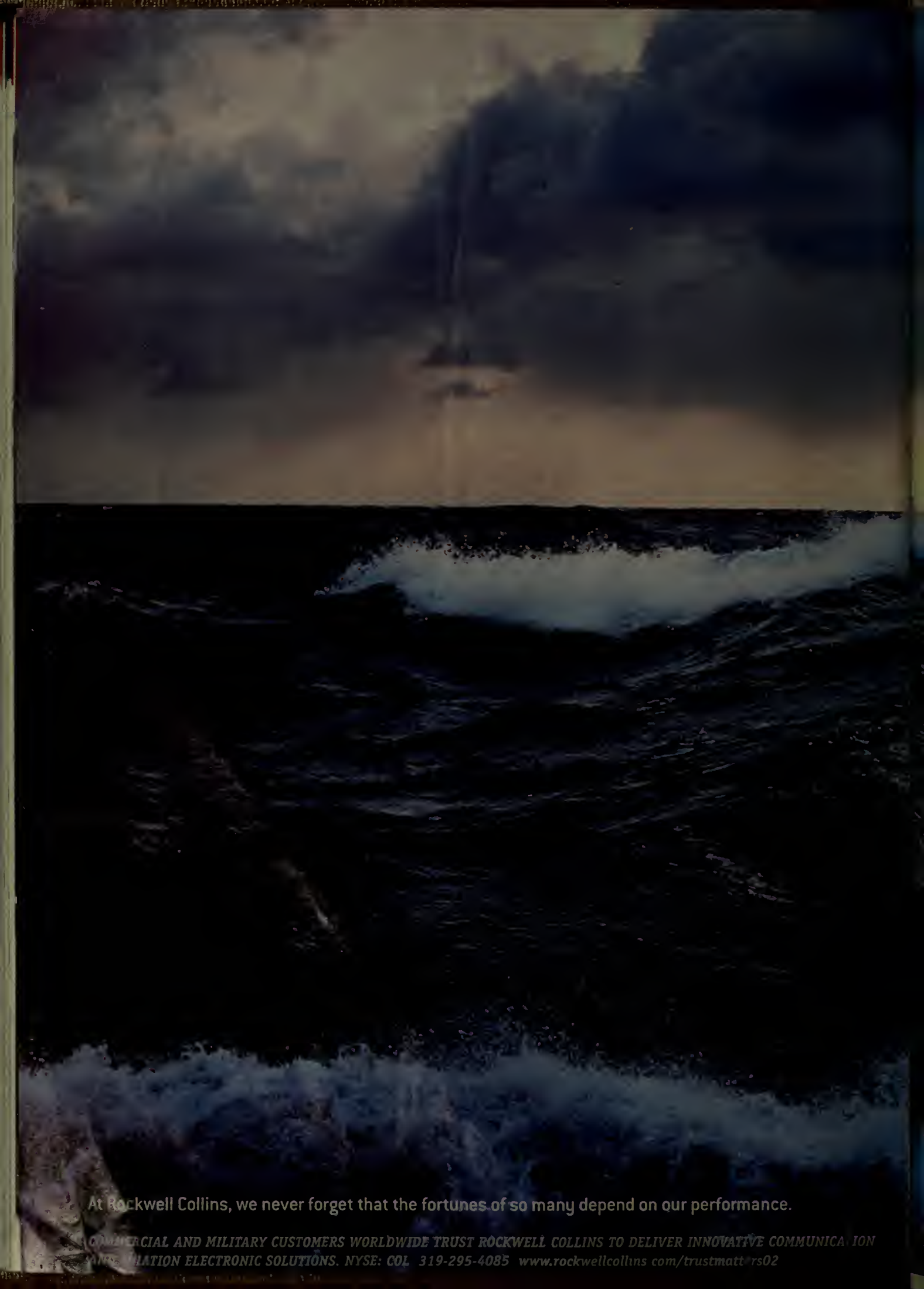
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FRIDAY, AUGUST 29, 2003 - VOL. CCXLII NO. 43 - ***** \$1.00

When it came to our tasting of "white goods," the superpremiums ruled the day. Here, our top three in each category, plus our tasters' comments:

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\$50 Crude: More Than Just Pain at the Pump

Recent weeks have seen a respite in oil's seemingly inexorable climb. But prices will most likely head back up—and if that happens, growth and the economy will be going down

194 ⁷/₁₀
214 ⁹/₁₀

Productivity Trumps Demographics

Repeated warnings that population growth—or lack thereof—would destroy economies have always turned out false. *BusinessWeek* Chief Economist Michael Mandel says today's greatest danger isn't an aging population, but a drop in productivity growth

Technology Special Report: Tomorrow's Safer Cars

Baby boomers will soon need help to avoid becoming hazardous drivers. And with technologies ranging from better dashboards to enhanced night vision, carmakers are gearing up



Pull the Veil from Drug-Study Secrets

Making the drugmakers register their studies and publish the results—good or bad—is just a first step toward much needed openness in the pharmaceutical industry

Will Ericsson See a Windfall From 3G Technology?

S&P analyst Ari Bensinger thinks the Swedish outfit's stock will gain substantially as wireless providers, after several years of capital-spending cuts, upgrade their networks with Ericsson's gear



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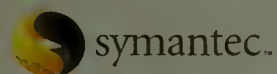
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"I am very sad that I will miss the holiday seasons."

—Martha Stewart, asking to serve and finish her five-month prison sentence as soon as possible

EDITED BY IRA SAGER

TECH LAND

TILL HUNGRY FOR FOREIGN VISA

RE, THE LABOR market remains sluggish, and plenty of B. tech workers still can't find good jobs. But that hasn't dampened employers' appetite for foreign workers: Companies are close to using next year's allotment of H-1B visas for skilled foreigners.

Employers filled this year's quota by April and were allowed to apply early for the 20,000 H-1B visas that will become available in fiscal 2005, which begins Oct. 1. So nearly 46,000 petitions for 2005 have come in, says the U.S. Citizenship & Immigration Services. So it's likely that the 20,000 cap will be met even before the new year.

Foreign workers' visas have provoked fierce debate. In 2000, workers' groups successfully fought temporary increases in H-1B visas, to 19,000. But a hike required this year, and the cap dropped back to 19,000. Employers have lobbied for another boost, but with jobs at an election issue, a bill in Congress is likely to remain for now. —Aaron Bernstein



CLEAN CALL
Applications for 2005 are pouring in



BALLOT BOX

Labor Calls in the Feds

AS THE ELECTION draws near, the AFL-CIO has found what it believes are financial shenanigans at a building trade group. *BusinessWeek* has learned that the union is asking the Internal Revenue Service and the Labor Dept. to investigate financial practices at 19 chapters of Associated Builders & Contractors (ABC), which supports GOP causes.

ABC has 80 chapters and 23,000 members, mainly construction businesses. Each chapter has an independent nonprofit trust to train new workers. In a review of ABC's records, the AFL-CIO says it found that some chapters seem to be charging the trusts inflated fees, taking inappropriate loans from the trusts, and failing to disclose other financial transactions. The fees paid to one Florida chapter grew more than 13-fold over a five-year period even as student head count rose by less than 70%, records show. A chapter official says

the cost increase was the result of program changes.

Edward Sullivan, president of the union's Building & Construction Trades Dept., says, "it now appears these programs are more valuable... as a source of money for their activities than for workforce training." In 2004, ABC gave \$1 million to GOP congressional campaigns.

If the allegations hold, ABC chapter employees could face

fines, loss of nonprofit status, or even jail time. CEO Kirk Pickerel calls the charges a "political smear campaign." He says the records examined by the AFL-CIO aren't detailed enough to support the union's conclusions.

The AFL-CIO and ABC clash on a number of issues, such as union-only labor on federal contracts. No wonder the union is eager to keep the heat on. —Jessi Hempel

THE BIG PICTURE

NAME GAME Recent gifts to U.S. B-schools by philanthropists and alumni that resulted in the school being named in their honor:

MILLIONS OF DOLLARS

STEPHEN ROSS, RELATED COMPANIES

UNIV. OF MICHIGAN \$100

SAMUEL GARVIN, CONTINENTAL PROMOTION GROUP

THUNDERBIRD \$60

DAVID TEPPER, APPALOOSA MANAGEMENT

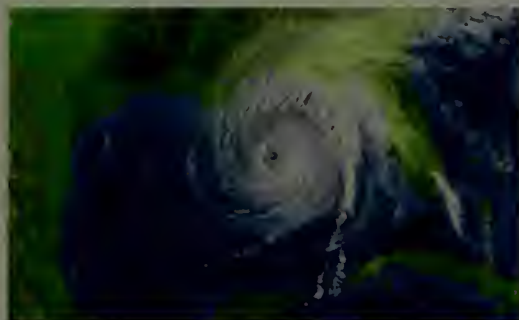
CARNEGIE MELLON \$55

Data: *BusinessWeek*

SUNSHINE STATE

APRES LE DELUGE, THE BILL

WITH DAMAGES from Hurricane Ivan yet to be tallied, companies with a large presence in Florida are



still reeling from two earlier storms.

Hurricanes Charley and Frances left a combined \$30 billion in damages, according to **Wachovia**. And Hurricane Ivan added to the devastation. Hundreds of millions of dollars of the tab for damages will be picked up by just a few insurance companies. **Allstate**, **Chubb**, **St. Paul Travelers**, and **Hartford** have estimated that they will pay out in total some \$600 million from Charley alone.

The earnings damage was not limited to underwriters, however. **Wal-Mart Stores** closed 150 of its outlets during the storms, hurting sales in the affected areas. **Federated Department Stores** blamed Frances for a \$20 million drop-off in September sales, and **Office Depot** says profits for the rest of the year will fall short of forecasts because of the storms. After canceling hundreds of flights on Labor Day weekend, **AirTran Airways** warned that it would be posting a third-quarter loss.

Companies that depend

on the tourist trade naturally took a hit. **Walt Disney** says the temporary closure of its Orlando theme park during Frances could cost the company as much as \$45 million in pretax earnings. **Carnival** says Frances forced it to cancel three cruises and shorten six others. The cruise line warned analysts

to trim 3¢ to 4¢ off earnings estimates for the fourth quarter ended Nov. 30.

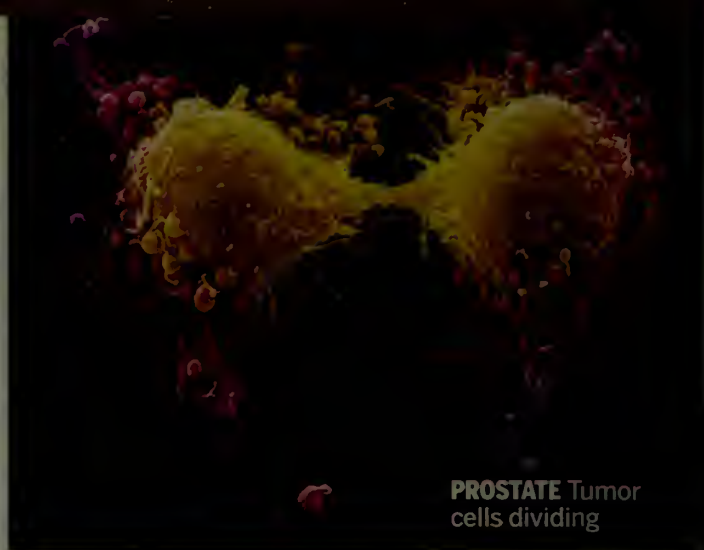
Some companies may actually benefit from the storms.

Home Depot and **Lowe's** are both

seeing strong demand as householders start to rebuild after boarding up. Other businesses should be so lucky.

—Louis Lavelle

IVAN Sweeping over the Gulf Coast



PROSTATE Tumor cells dividing

HEALTH WATCH

CANCER TEST A pioneer of the widely used prostate specific antigen (PSA) screening test for cancer now says it is "all but useless." In 1987, Dr. Thomas Stamey of Stanford University found that rising PSA levels could be linked to prostate cancer. But in a new study in October's *Journal of Urology*, he says PSA levels indicate only the size of the prostate gland. **The test's ability to predict cancer can be as low as 2%.** Until a better test comes along, he says men over 50 should have a digital rectal exam yearly. Some experts worry that PSA tests have led to needless treatment—such as radiation for tiny tumors that could have been left alone.

—Catherine Arn

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UP Front

FACE TIME

MARK CUBAN



DVDs? HE'S NOT IMPRESSED

Here's a piece of advice budding billionaires could get on **Mark Cuban's** new ABC reality show, *The Benefactor*: Ditch your DVDs. Cuban, the dot-commer turned NBA team owner, also owns a high-definition TV network, HDNet, and he's busy buying content, from old sitcoms to low-budget movies shot in high-def.

Soon he'll start offering those shows to home libraries—but not on DVD. Cuban, 46, prefers hard-disk drives because they hold more, are dropping in price, and are recordable. "Hard-drive distribution will become a no-brainer," says Cuban, whose show premiered on Sept. 13.

Industry experts say DVDs are here to stay. But Cuban predicts that soon you'll be able to buy a high-def movie on a pocket-size hard drive that plugs into a laptop or TV. On DVD that would take five disks. New movies could be downloaded at airport or mall kiosks. "He's defining new opportunities to make money," says In-Stat/MDR analyst Gerry Kaufhold. Maybe Cuban really is a benefactor. —Andrew Park

DEALS

MGM: THE GIFT THAT KEEPS ON GIVING

HOW MANY TIMES can a mogul sell his empire? Kirk Kerkorian's pending sale of **Metro-Goldwyn-Mayer** to a consortium led by **Sony**, is the third time the 87-year-old billionaire has sold the fabled studio. In all, the deals have earned him profits in the neighborhood of \$3 billion.

Kerkorian, who controls a 73.6% stake in MGM, is expected to collect nearly \$2.1 billion if Sony's \$12-a-share bid is completed. With an estimated cost basis of \$8 a share for his 174 million shares, according to MGM, that's a hefty \$700 million profit. That's on top of \$1.4 billion he collected from a one-time \$8-per-share dividend MGM gave shareholders in May.

MGM has been the gift that keeps giving ever since the reclusive dealmaker first won the studio in a 1969 proxy



GOLDEN ASSET MGM owns the James Bond series

battle. He made his first sale to Ted Turner in 1986, for \$1.5 billion, netting \$480 million for his 50.1% stake. He then spent \$300 million to buy back the United Artists studio, MGM's home video unit, and the rights to MGM films such as *Moonstruck*, *A Fish Called Wanda*, and the

TV series *Fame*. In 1990, Kerkorian sold the rebuilt MGM again, this time for \$1.3 billion to media concern **Pathe Communications**. He regained possession in 1996 after Pathe's bankruptcy.

Add the profits from a casino spin-off and sale, and **Lionel** the Lion has put plenty cash into Kerkorian's account over their 35 years together. —Ronald Groves

WORKPLACE

YOUNG AND OLD The median age of a U.S. worker in 2003 was 40.4 years old, up slightly from 40.1 in 2002. Restaurant hosts and hostesses had the youngest median age, barely edging lifeguards, while bridge-and-lock tenders (54.7) narrowly eclipsed farmers and ranchers as the oldest:



HOSTESS

21.3



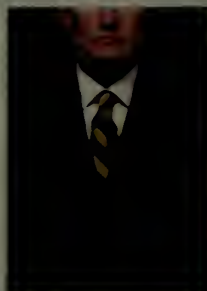
FIREFIGHTER

38.3



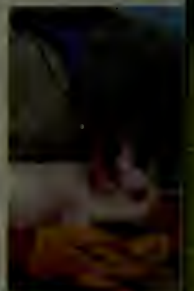
NURSE

43.1



CHIEF EXEC

48.2



FARMER

54.0

Data: Bureau of Labor Statistics



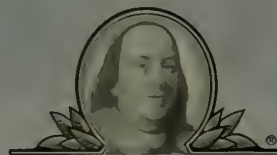
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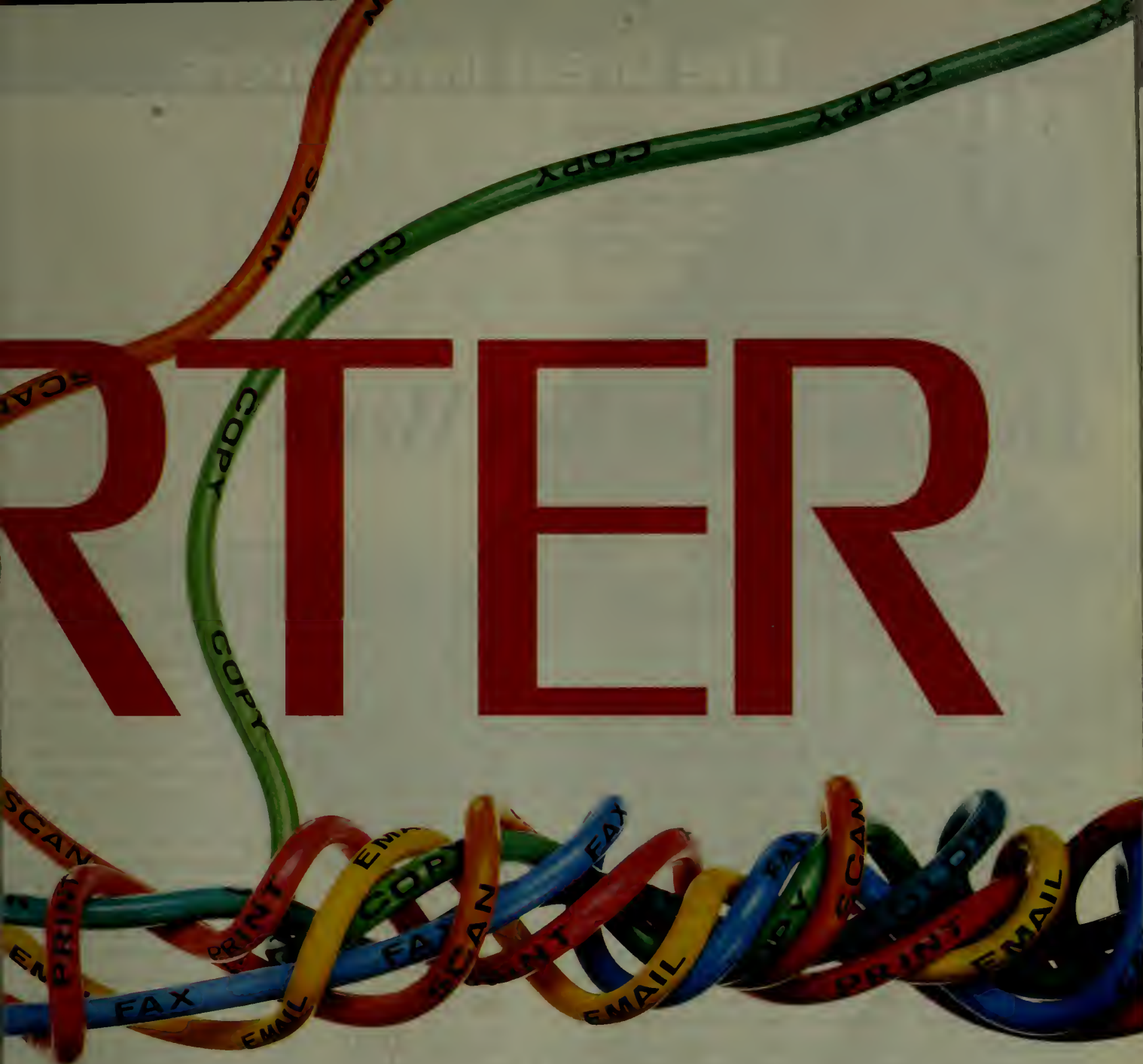


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CELEBRATING



As part of its anniversary celebration, BusinessWeek is presenting a series of weekly profiles of the greatest innovators of the past 75 years. Some made their mark in science or technology; others in management, finance, marketing, or government. In late September, 2004, BusinessWeek will publish a special commemorative issue on Innovation.

He Made the Net Work

A HALF-DOZEN INDIVIDUALS have been hailed as father of the Internet. Scores of others also had a hand in birthing this network. But the person who sifted through the contending technologies and drew up the blueprint for a networking infrastructure—then actually made it work—was Lawrence G. Roberts.

Roberts' baby was ARPAnet, the Internet's predecessor. But he never laid claim to the original idea. The Net's inspirational father was J.C.R. Licklider (1915-90), a psychologist at Massachusetts Institute of Technology who outlined his dream of a Galactic Network in the early 1960s. Then, during a stint at the Pentagon's Advanced Research Projects Agency, or ARPA (now DARPA), "Lick" pretty much described today's Net.

At a fateful meeting with Lick in 1964, Roberts became a disciple. Still, when ARPA attempted to recruit him to oversee the network project, Roberts held back, worried that the administrative duties would be boring. Finally, in December, 1966, at age 29, he acquiesced. The next year, Roberts outlined his networking scheme at conferences and meetings with researchers. Scientists often resisted his call to share

their computers, which were rare and expensive resources back then. But ARPA held the purse strings for much of the funding, so Roberts was hard to resist.

ARPAnet's key building blocks came from such researchers Leonard Kleinrock and Paul Baran in the U.S. and Donald W. Davies in Britain. Each devised an approach to "packet switching," which solves bandwidth constraints by slicing transmissions into small packets and shooting them over the same wires. To develop a network-control protocol that would impose some order on packet switching's intentional chaos, Roberts relied on Vinton G. Cerf and Robert E. Kahn. In the late 1970s they refined this into TCP/IP, or Transmission-Control Protocol/Internet Protocol, the technology still in use today.

The call to build ARPAnet's first hardware went out in 1969.

Larry Roberts persuaded scientists to share their computers

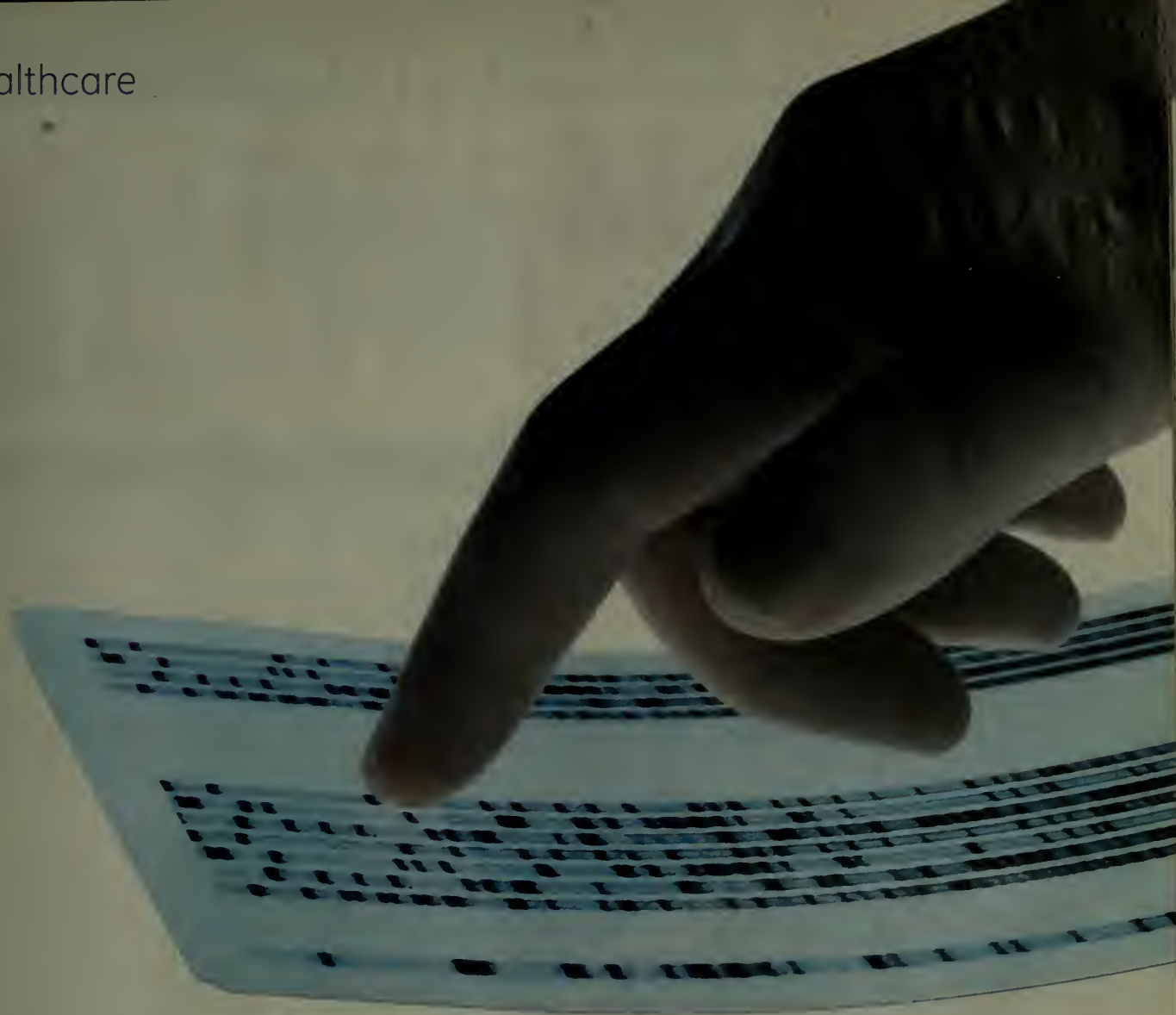
It triggered a flood of proposals that stacked up almost seven feet high and taxed even Roberts' speed-reading skills—2,400 words per minute. Roberts selected Bolt Beranek & Newman (BBN) to build the first network switch. The initial units went to Kleinrock at the University of California at Los Angeles and Douglas C. Engelbart at Stanford Research Institute in 1969. BBN got the East Coast "node" in 1970. After BBN's Ray Tomlinson wrote the first mail program in 1971, scientists began flocking to the Net.

Roberts left ARPA in 1973 to found Telenet Communication Corp. as a BBN subsidiary (now part of Sprint Corp.). It was the first commercial packet-switched network. Today, Roberts continues to dream of bigger, better, faster networks. In 1991 he founded Caspian Networks Inc. to develop switches for multimedia traffic such as movies and radio broadcasts. Movies weren't even glint in Roberts' eye in 1967, but he emerged as the star of the Internet drama. ■

—By Ott



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imagination at work

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[The federal] deficit requires Americans to borrow about \$2 billion from foreigners every working day."

—Daniel Kirkdorffer
Redmond, Wash.



SOUNDING OFF ABOUT BUSH'S "OWNERSHIP SOCIETY"

IF PRESIDENT George W. Bush really wanted an "ownership society," he would support the Securities & Exchange Commission's rule to allow stock owners to place a token number of board nominees in the corporate proxy ("Bush's agenda," Cover Story, Sept. 6). Instead he is bowing to his managerial friends at the Chamber of Commerce and the Business Roundtable, holding back on a rule that would empower owners. Bush's vision favors those who manage other people's money, not an ownership society. In contrast, Senator John F. Kerry (D-Mass.) says "the SEC should allow long-term significant investors to have a voice in the selection of a portion of a company's board of directors."

—James McRitchie
Elk Grove, Calif.

"I WANT PEOPLE owning something in America" said President Bush in announcing his ideas for the future. He and the Republican leaders of this country have certainly done their part to ensure that Americans for many years to come will have part ownership of the largest

federal deficit our nation has ever seen

It is time we all owned up to the reality that as of August, the total national debt was more than \$7.3 trillion and that this deficit requires Americans to borrow about \$2 billion from foreigners every working day. I guess some people do own something in America under this Administration—just not Americans.

—Daniel Kirkdorffer
Redmond, Wash.

AS A LONG-STANDING reader of your magazine, I was surprised by your objection to Bush's Social Security initiative ("Our take on the GOP's economic plans," Editorials, Sept. 6).

You state that the proposal is based on ideology, not economics, and therein lies the fallacy of your argument. Economics in a free society should be based on freedom of choice, rights to property, and building of assets and capital. Within this framework, you bet the plan is based on ideology.

By allowing individuals to decide what to do with their own contribution to their retirement, the President is not destroying the safety net—rather, Bush is allowing individuals to own it. The fact

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(OR AS IT CAME TO BE KNOWN)

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Readers Report

that the system is not broken is irrelevant.

—Carroll Stein
Roscoe, Ill.

OUR SPOTLIGHT ON PENSIONS HITS THE MARK

"PENSIONS ON A precipice" was a fine article (News: Analysis & Commentary, Sept. 6). Bailing out the Pension Benefit Guaranty Corp. is something the middle class can't afford. Too bad every politician doesn't read *BusinessWeek*.

—LaVern F. Isely
Monroe, Wis.

IN PRAISE OF W. EDWARDS DEMING

"THE KINGS OF quality," about Joseph M. Juran and W. Edwards Deming, seriously understated the contribution Deming made in teaching his theory of management (The Great Innovators, Aug. 23-30). In fact, his theory went well beyond simply dealing with the application of statistical methods in manufacturing. I was fortunate to have had extensive relationships with Deming and also Peter F. Drucker during my time as president and then chairman and CEO of Ford Motor Co. Deming served as a consultant to Ford through much of the '80s.

Two of his theories of management alone were worth his consulting fee. In one, he stressed that if you are having a problem, 9 times out of 10 your problem rests with management. How true! A second point I found most helpful was the power of continuous improvement. His was a rich mind, full of extremely helpful management insights.

—Donald E. Petersen
Chairman and CEO (retired)
Ford Motor Co.
Bloomfield Hills, Mich.

BROADBAND: WHY THE U.S. IS LIKELY TO FALL FURTHER BEHIND

"BEHIND IN BROADBAND" (Information Technology, Sept. 6) described quite clearly that U.S. policies and the actions of the incumbent Bell telephone companies will cause the U.S. to fall even further behind other economically developed countries in terms of broadband deployment. Recent legal actions by the Bell telephone companies to block fair and open access to their local networks at cost-effective rates will eliminate any progress that has been made.

Why are pro-competitive regulatory policies still essential for the U.S.? The incumbent Bell phone companies inherited a monopoly infrastructure that remains the only ubiquitous last-mile access to the

doorstep of every home and business. Access to the last-mile network is, in essence, a public good and must remain available on an unbundled basis to competitors seeking to provide new and innovative services. Those competitors, such as XO Communications Inc., have invested billions of dollars to build the most technologically advanced networks capable of providing innovative broadband services demanded by businesses and consumers. For these investments to continue, competitive carriers need the assurance that they will have access to last-mile facilities at cost-effective rates to deliver these services.

—Carl J. Grivner, CEO
XO Communication
Reston, Va.

EVERYONE BENEFITS FROM SHAREHOLDER LAWSUITS

LOUIS LAVELLE'S commentary "Smoke mirrors, and shareholder settlements" missed the big point that these creative value-enhancing settlements were impossible five years ago (Management, Sept. 6). The reforms they have achieved, beginning with the Cendant Corp. litigation led by the California Public Employees' Retirement System, promise to strengthen corporate accountability, reduce risk, and improve returns. Studies by McKinsey & Co. and others demonstrate that institutional investors consider well-governed companies more valuable. Other studies link good governance to better long-term stock performance.

Lavelle claims that these settlements take the pressure off companies to reform. In my experience, these settlements often are the only way to get any reform. What is most promising about shareholder settlements are not terms that simply demand that the malefactors abandon the companies they have damaged but the imposition of healthy systems of accountability. Forcing out bad apples is relatively easy. The settlements focused on the tougher job: stopping the rot.

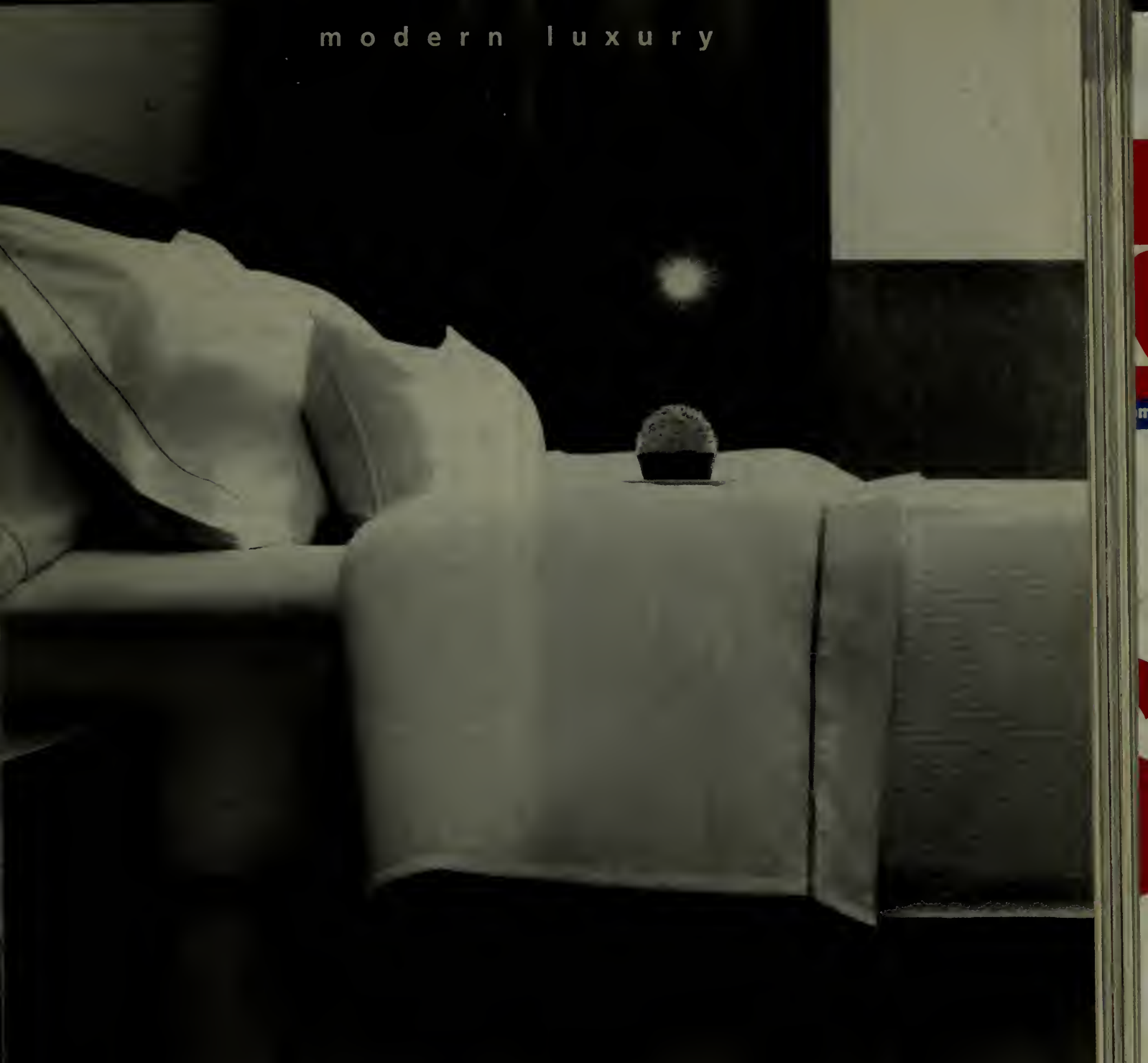
—Richard A. Bennett
Lens Governance Advisor
Portland, Me.

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The Stepford Kids

BORN TO BUY The Commercialized Child and the New Consumer Culture

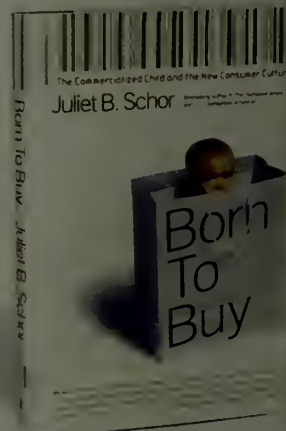
By Juliet B. Schor; Scribner; 275pp; \$25

If it has been a few decades since you've visited an American public school, you'd probably be shocked to see how much some of these once-sacred temples of learning now have in common with the mall. The walls of many sports stadiums are smothered in corporate logos. Most lunchrooms could double as fast-food

courts. And classroom TV monitors flash a regular stream of racy video-game, movie, and fast-food ads along with the TV news shows that get piped to 40% of U.S. teens. Corporations have even made "huge inroads" in the curriculum, thanks to the free materials they send to schools says Boston College sociologist Juliet B. Schor. Among the things grade-schoolers have been taught: that fossil fuels may pose few environmental problems and that alternative energy is costly and unattainable, in the words of Exxon's Energy Cube curriculum. They've also learned that the "earth could benefit rather than be harmed from increased carbon dioxide" from materials provided by the American Coal Foundation.

These are just a few of the many reasons why Schor believes that Corporate America has succeeded in a frightening, *Stepford Wives*-like takeover of tween consciousness. In her artfully argued, important exposé, *Born To Buy: The Commercialized Child and the New Consumer Culture*, Schor draws on interviews with marketers, academic research, and her own survey of Massachusetts fifth- and sixth-graders. Her chief villains: "predatory" marketers who go so far as to pay parents and schools to get access to kids. Because kids have gotten so skeptical, companies have countered with more craftiness. They hire cool alpha boys to flack products to their pals. They find "It" girls to host slumber parties and then ply their friends with products.

Nowhere is the onslaught more apparent than on TV and the Internet, says Schor. Against the \$15 billion lavished on commercials, "neuromarketing," and covert peer-to-peer campaigns, Schor believes grade-schoolers don't stand a chance. Marketers have sidestepped gatekeeper moms and



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ads and gone directly to kids: Much of their work in schools and on the Net is so stealthy that parents aren't even aware of it. Thus, Schor argues, too many children have been transformed into miniature consumption machines who keep wallowing the corporate message that meaning comes from acquiring and a sense of self-worth from owning. You don't have one? What a loser.

Schor also argues that marketed leisure has replaced unstructured socializing as the primary childhood pastime. Instead of Kick the Can, it's Buy at the Store. One national survey Schor points to found that more than a third of all kids age 9 to 14 would rather spend time buying things than doing almost anything else. Schor uses her own study to buttress the point: She found that the more exposed kids are to the consumer world, the more likely it is that they will suffer from depression, anxiety, and sagging self-esteem.

Such surveys are not totally persuasive: Kids are subject to many influences, making it extremely difficult to establish specific cause-and-effect relationships. And at times, Schor relies too much on the academic's lofty, list-heavy, fact-after-fact approach. *Born to Buy* would have benefited from more narrative, anecdotal sugar in the form of compelling characters to make the medicine go down.

Still, the book is a worthy capstone to the consumer trilogy that Schor began with her best-selling *The Overworked*

American (1991) and continued in *The Overspent American* (1998). Those two books focused on the addictive cycle of earn to spend, only to amass one's way into bankruptcy. Schor's observation that dual earner, time-crunched adults were sometimes engaging in easy-pass parenting, with scant time to lay down rules at home, prompted her to begin the research for *Born to Buy*.

Schor doesn't blame moms who don't stay at home. Even the most attentive of full-time

parents can lose the battle against the onslaught of stuff-sellers. Still, Schor believes parents should lobby government to regulate ads and turn schools back into commercial-free zones. In her own home, Schor decided get rid of the TV until her kids asked for it. They never did.

But, Schor asks, should parents really have to fight against every message beamed at their offspring? Is the only option a kids-in-a-bubble childhood? What about a culture that supports youngsters rather than enticing them to spend money? The way it stands now, advertisers use every means to capitalize on the "nag factor"—inciting kids to pester their parents until they open their wallets. Marketers have even enlisted academics, Schor says, much as Big Pharma has done with doctors. For example, toy companies hire researchers to study a game and find it "instructional," thus giving it a parental halo. The marketers Schor interviewed admitted to guilt over their tactics, with one even confiding that she was sure her career would cause her to "burn in hell."

Still, that ad whiz shows up at her agency every day, working away in service to a mega-client obsessed with capturing and nurturing its "future market." Schor's point: If these trends continue, what kind of future will it be? ■

—By Michelle Conlin

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The World of Golf



The history of the Ryder Cup

The biennial competition bringing together the finest golfers from either side of the Atlantic had an improbable patron. Born in 1858, Samuel Ryder made his fortune selling seeds to English gardeners, taking up golf relatively late in life, allegedly as a palliative for exhaustion brought on by overwork.

Although Ryder himself was a competent amateur, his association with the competition that has borne his name since the opening match at Worcester, Massachusetts in 1927 was neither long nor especially happy. Ill health prevented him from realizing his ambition of attending a Ryder Cup match in the US, and by the time of his death in 1936, he had witnessed just one British victory – a nail-biter at Southport in 1933 won by 6.5 points to 5.5.

AFTER 40 HOURS OF GOLF, WITH THE SCORES TIED AT 15.5 EACH, THE OUTCOME CAME DOWN TO THE FINAL PUTT AT THE LAST HOLE.



Nor, in the years to follow, would the Ryder Cup be a happy tournament for the British, who between 1933 and the mid 1980s would record just a single outright victory. That came at Lindrick Golf Club in 1957 when a spirited British team led by Dai Rees recovered from trailing 3-1 to take the Cup by 7.5 points to 4.5.

The Americans exacted their revenge with convincing victories in the next five meetings, and when the teams assembled at Royal Birkdale in September 1969

there was no reason to anticipate anything other than a decisive American triumph. Instead, the 16 golfers played out the closest competition in the history of the Ryder Cup. After 40 hours of golf, with the scores tied at 15.5 each, the outcome came down to the final putt at the last hole of the last match between America's Jack Nicklaus and Britain's Tony Jacklin. Nicklaus effortlessly sunk his four-foot putt, and in a gesture of sportsmanship which would be unthinkable today, conceded the two-footer to his young opponent.

The cliff-hanger of 1969 proved to be a false dawn for the Europeans. Normal service was restored with American victories on either side of the Atlantic throughout the 1970s, and by the end of the decade new proposals were being made to redress the balance between the two unevenly matched teams. One such proposal that had been rejected at the end of the 1960s had been to invite Commonwealth golfers into the British team. More acceptable, as closer European integration gathered momentum in the 1970s, was the idea of expanding the British team to include representatives from Continental Europe.



1929 Ryder Cup at Moortown, Leeds. Samuel Ryder, the donor of the Ryder Cup, presents the trophy to winning captain

In the short term, bringing Europeans into the Ryder Cup fold in 1979 did little to loosen the Americans' grip. The two Spaniards, the experienced Antonio Garrido and a 22 year-old named Severiano Ballesteros, battled gamely at The Greenbrier, but America took the first match against a European team by 17 points to 11.

Nevertheless, the 1979 Ryder Cup represented the start of a new era for European golf. Ballesteros himself would become one of the most accomplished European golfers of all time, winning 20 of his 37 Ryder Cup. And it was Ballesteros who captained the winning team in the first Ryder Cup held in his native Spain, at Valderrama in 1997, one of a series of victories which, since 1985, have seen Europe take the Cup five times, with the Americans chalking up three wins, and 1989's contest tied. As they will be enjoying home advantage at this year's contest at Oakland Hills, Michigan, the Americans will fancy their chances of chalking up their 26th outright victory.

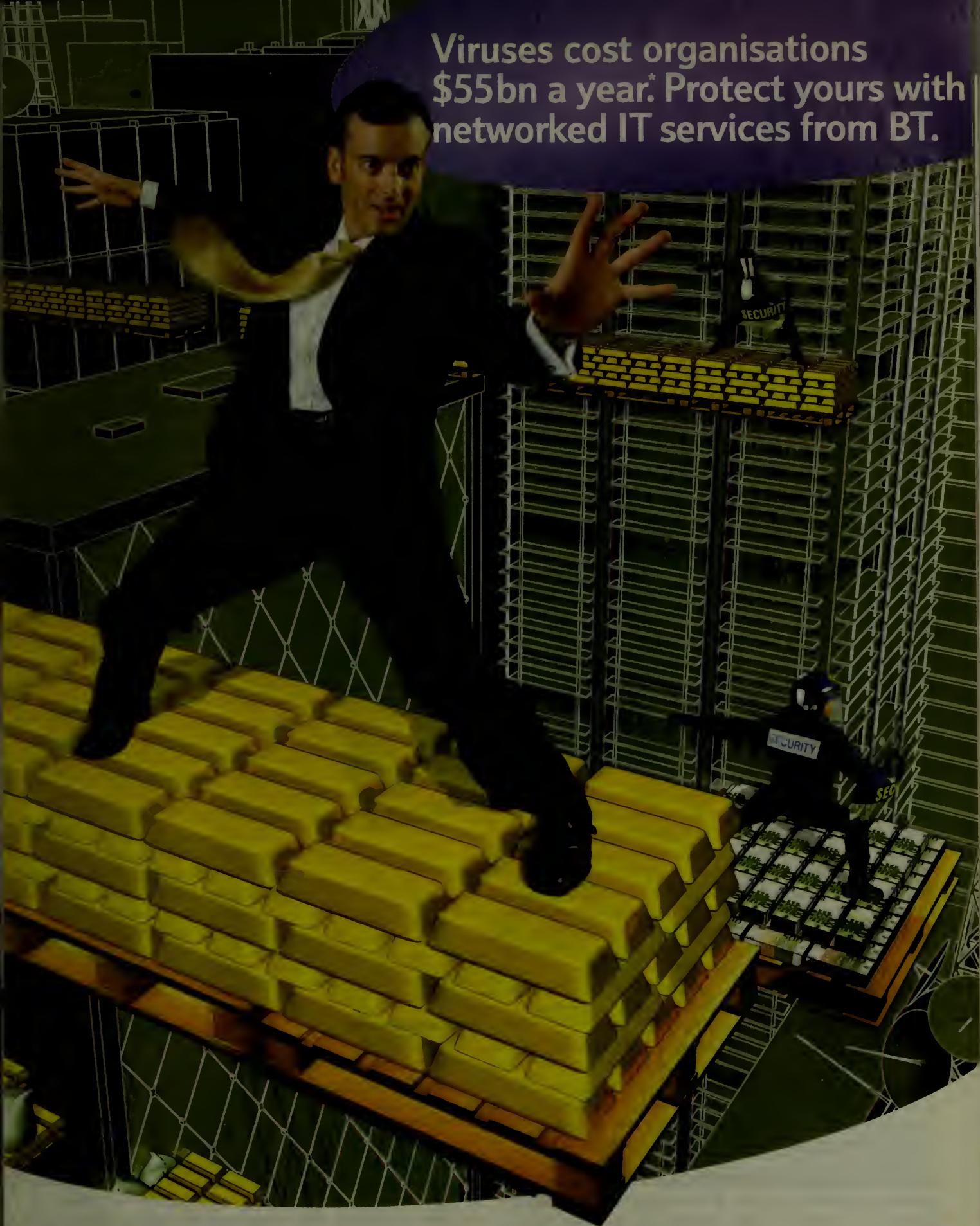
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More power to you



BY STEPHEN H. WILDSTROM

Tablets: Waiting for More Smart Software

By Microsoft's standard, the Tablet PC is a flop, with sales of computers using the pen-ready version of Windows XP in the hundreds of thousands, not millions as forecast by Chairman William H. Gates III two years ago. Today, the Tablet is stuck mostly in such vertical markets as insurance and health care. Yet it remains one of Microsoft's most interesting experiments.

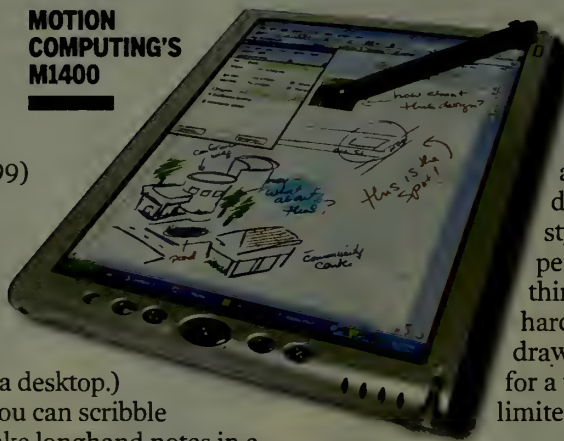
The Tablet, introduced in 2002, gives users the ability to write directly on the screen with an electronic stylus, so they can work without a keyboard or mouse. I have been trying out a new M1400 Tablet (\$1,999) from Motion Computing and Microsoft's just-released Tablet PC 2005 software. The M1400 is a slate-type Tablet, meaning its normal use is tucked in the crook of your arm with no keyboard. (A variety of docking arrangements also make it usable on a desktop.)

In Microsoft Office, for example, you can scribble comments on a Word document or take longhand notes in a program called OneNote and use limited handwriting recognition to turn your scrawl into text. With the original Tablet software, you also had to spend a lot of time tapping out letters on an on-screen keyboard for such chores as entering an appointment in Outlook. That's now less necessary. A panel that converts handwriting to text pops up when needed. And a new option lets the Tablet recognize one character at a time so that you can enter information such as a Web address without having the recognition software mangle it by attempting to convert it to ordinary English words.

Still, I think Microsoft is hobbling the Tablet's future by marketing it primarily as a way to take notes on a screen. Paper and pen are perfectly good for that. And the convenience of storing notes as "digital ink" isn't worth having to carry a three-pound slate that gets toasty in your arm and depends on a battery that is good for no more than four hours.

THE TABLET'S GREATEST POTENTIAL lies in its ability to perform feats that cannot be done by typing on conventional laptops. For example, a major impediment to using computers for a lot of mathematical work has been the difficulty of entering math notation from a keyboard. MathJournal from xThink (\$198, \$98 for students) lets you write on the screen in conventional math notation. It parses the input and performs sophisticated calculations, including equation-solving, symbolic integration, and vector operations.

**MOTION
COMPUTING'S
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SketchBook Pro from Alias Systems (\$179) lets you create complex freehand drawings directly on the screen. If you have ever tried to draw something with a mouse, you can guess how much simpler and more accurate it is to use a pen directly on the display. On the Tablets, the stylus becomes a vast array of virtual pens, pencils, and brushes. And, just like the real things, the electronic tools respond to how hard you press. Systems that allow pen-based drawing on external displays have been around for a while, but their complexity and expense limited their use to professional artists.

Although not designed for the Tablet, AutoSketch (\$129) from Autodesk, a technical drawing program, is easier to use with a pen than a mouse.

The bulk of Tablets sold have been "convertible" models that build Tablet functions into a clamshell laptop with a display that can rotate. I find the slate design more natural because it's lighter and easier to use on the

Microsoft is hobbling the tablet by aiming at the wrong crowd

go. The Motion M1400 is clever, featuring a fingerprint reader that can end the tedious chore of entering passwords with the stylus, and an optional combination keyboard and stand (\$130) that doubles as a cover for the slate.

Now we need better software. Just about any program that allows for direct manipulation of objects on the screen, from entering notes in a musical score to creating relationships among items in a database, can profit from the Tablet's unique abilities. With more programs such as MathJournal and SketchBook, the Tablet could reach its potential. ■

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BY LAURA D'ANDREA TYSON

There's Nothing Macho About Soaring Deficits

At the Republican National Convention, California Governor Arnold Schwarzenegger branded those who question the health of the American economy as “girlie men.” According to this characterization, girlie men include Federal Reserve Chairman Alan Greenspan and Blackstone Group Chairman Peter G. Peterson, who warn about the dangers of huge federal

budget deficits; hardheaded bear traders in global financial markets; and numerous economists, including those at male-dominated financial firms, who worry about the sustainability of the economic expansion.

Alas, there's plenty of evidence to suggest that the concerns of such girlie men are valid. By most conventional measures, the recovery from the 2001 recession has been remarkably weak. Annual growth in real gross domestic product has averaged 3.4%, vs. the 5% average of the previous six business cycles. Job growth has been the slowest of any recovery since the Great Depression. Wage growth, too, has been shabby. Real wage and salary disbursements have been rising less than 1%, on average, vs. the norm of nearly 4% for previous recoveries. During the past year, real hourly and weekly wages for production and nonsupervisory workers actually declined. The real value of the minimum wage is down to a 40-year low.

Perhaps that doesn't matter to macho Republicans, since more than 60% of minimum-wage workers are “girlie girls.” But many thinking men are disturbed by the fact that wages are the lowest share of GDP since 1929. Most of the paltry job growth has been in low-wage positions that pay less than average and are less likely to provide health benefits. That's one reason 5.2 million more Americans have lost their health insurance, bringing the total number of uninsured to 45 million, an all-time high. For the typical American family, which depends on income from work rather than capital, the economy's torpor has meant a drop in real income of more than \$1,500 from 2000 to 2003.

THE ECONOMY'S POOR JOBS PERFORMANCE is all the more remarkable because it has been fueled by an unprecedented amount of monetary and fiscal stimuli. Using a metaphor that Schwarzenegger might get, the economy has been on steroids during the past three years. Now tax cuts for the middle class are over, and the Fed is raising interest rates. Serious girlie men are asking whether the economy can withdraw from its dependence on policy stimulus without major side effects.

Since 2000, the federal budget has suffered its largest swing from surplus to deficit during a three-year period. Huge structural budget deficits—5% to 6% of GDP, if temporary surpluses in the Social Security and Medicare trust funds are

excluded—are projected for the next 10 years, after which they will soar as baby boomers retire. According to the Administration's *Mid-Session Review*, the 2001 and 2003 tax cuts account for over half of the 2004 budget deficit and have contributed more to increasing the deficit than the costs of homeland security, the war on terrorism, Iraq and Afghanistan and the growth in domestic spending programs combined.

Vice-President Dick Cheney claims that deficits don't matter, but a growing consensus among economists is that long-term interest rates are likely to rise at least a percentage point as a result of the widening structural budget deficit. Most Americans live in a debt society, not an ownership society. Higher rates will hit them hard.

‘Girlie men’ are raising serious questions about the economy

In his speech, Schwarzenegger derided girlie men for fretting that nations such as Japan and China will overtake us. The real problem is that they will stop lending to us on attractive terms. During the past few years, about 80% of the fiscal deficit has been financed by foreigners, primarily the central banks of Japan and China. Robert E. Rubin, former Treasury Secretary and apparently a girlie man, recently cautioned that large budget deficits could trigger a sudden loss of confidence in

America by foreign lenders, causing a sharp decline in the dollar, a spike in U.S. interest rates, and a painful recession.

Haven't we reached a sort of national nadir when the exercise of analytical intelligence is derided as effeminate? Those concerned about trends in the economy during the Bush Presidency aren't wimps or pessimists but thinking men and, yes, women. And many of these thinking persons are optimists who believe that with wise Presidential leadership, the U.S. economy can do much better, as its performance during President Clinton's stewardship demonstrated. ■

Laura D'Andrea Tyson, dean of London Business School, chaired the Council of Economic Advisers from 1993 to 1995 and is an informal adviser to Democratic Presidential nominee John Kerry.

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A woman with dark hair is in a yoga pose, with her hands pressed together in front of her chest. She is wearing a light-colored tank top. The background is a room with many small, colorful photographs or posters pinned to the wall. The lighting is warm and slightly dim.

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What if we ended world hunger?

BY JAMES C. COOPER & KATHLEEN MADIGAN

That Spring Slowdown? Just a Bad Dream

After faltering in the second quarter, growth is rebounding nicely

U.S. ECONOMY Back in the spring, the recovery was looking shaky. Growth in the economy was slowing as consumers struggled with high gas prices. Many businesses put their hiring plans on hold. And inflation, even outside of energy, was picking up, potentially putting the Federal Reserve in the fix of having to raise rates in a slowing

economy. But that was then. Now it's all starting to look like little more than a bad dream.

To be sure, residual effects of costlier energy, increased business caution, and a global slowdown still exert some downward pressure on the growth of consumer spending, business outlays, hiring, and exports. But more and more data for the third quarter suggest that consumer demand, industrial output, job gains, and overall economic growth are rebounding from their second-quarter dips. The data also show that inflation is cooling, a turnaround that's now helping the buying power of household incomes.

Moreover, upward revisions to several key data in the second quarter suggest last quarter's slowdown was not as sharp as first thought. Given that June construction spending, exports, and inventories now look stronger than originally reported, several research units on Wall Street believe the Commerce Dept. will lift its estimate of second-quarter growth in real gross domestic product from 2.8% to around 3.4% on Sept. 29.

WITH THE ECONOMY MOVING OUT of its soft patch and regaining "some traction," as Fed Chairman Alan Greenspan told Congress recently, the Fed is clearly on course to hike its target federal funds rate by another quarter-point, to 1.75%, at its Sept. 21 policy meeting.

Indeed, with 4% growth in the second half looking more likely, similar hikes at the Fed's November and December meetings cannot be ruled out. Given that the Fed's favored measure of core inflation, which strips out energy and food, is running at 1.5%, even a 2% federal funds rate would imply an unusually stimulative policy.

One important sign that the economy is getting back on firmer ground is the rebound in the industrial sector. Last year the upturn in industrial output was a key signal of renewed economic strength generally, and the same implication is most likely true now.

Output in the nation's factories, utilities, and mines rose 0.1% in August, but that gain was depressed by a drop in utility output, reflecting unusually cool weather. Production in manufacturing alone increased 0.5% after a 0.9% gain in July, and growth from the previous year

is now on a par with the rapid pace of output growth in the late 1990s (chart).

Manufacturers are benefiting especially from the efforts of companies to restock inventories to levels that are better in line with the pickup in demand that began last year. Inventory growth, by itself, accounted for 1.2 percentage points of the first quarter's 4.5% advance in real GDP. And with more complete inventory data now in hand, the Sept. 29 revisions should show that stock-building contributed more to last quarter's GDP growth than the 0.7 percentage point now on the books.

Also, the faster pace of inventory growth appears to be continuing in the third quarter. Businesses in the manufacturing,

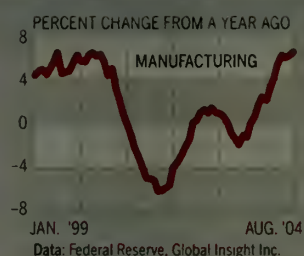
wholesale, and retail sectors increased their stock levels by 0.9% in July, on top of June's 1.1% rise, which was the largest monthly increase in 4½ years.

A key sign that businesses are serious about adding to their inventories is the upturn in the volume of commercial and industrial loans that began in June, after a steady 3½-year decline (chart, page 34). The pattern of C&I loans has always been highly correlated with inventory trends, because businesses rely on them to finance their stockpiles.

IT'S EASY TO SEE WHY businesses are rushing to rebuild their inventories. First, the July ratio of inventories to sales, while up from its record low in March, remains at a level suggesting that stockpiles are extremely thin. So any worry about an unwanted inventory buildup that could depress future production is far from warranted. Second, as widely expected, most notably by Fed officials, the demand slowdown has proved transitory.

Consider consumer demand. The Commerce Dept. reported that retail sales fell 0.3% in August, but the drop

INDUSTRIAL OUTPUT IS GROWING RAPIDLY



was concentrated in motor vehicles. Excluding cars, sales rose 0.2%. And the total July number was revised up to show an increase of 0.8%, instead of 0.7%.

The gains probably extended into September, although hurricanes Frances and Ivan might skew the data for sales in the Southeast. Weekly store surveys for the week ended Sept. 11 showed improvement over the previous week. Real consumer spending will probably grow at an annual rate of about 3.5% in the third quarter. That would be twice the 1.6% second-quarter advance.

Foreign demand also got off to a better start in the third quarter than it did in the second. Exports of goods and services jumped 3% in July, after falling in two of the previous three months. The gain in exports, coupled with a drop in imports, narrowed the trade deficit from a record \$55 billion in June to \$50.1 billion in July.

Even so, the continued high price of oil and the need to replenish oil inventories in the U.S. mean that foreign trade will probably be at least a small negative for U.S. growth in the second half. In addition, high energy prices, along with China's goal of cooling its economy, has raised uncertainty about global growth, which could curtail demand for American-made goods.

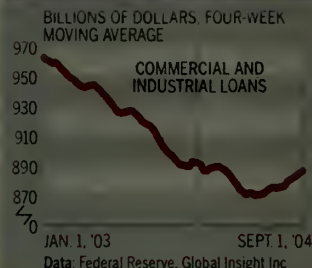
THE CHINA SLOWDOWN hasn't yet affected U.S. exports. So far this year, shipments to China and other Southeast Asian countries are rising faster than they did for all of 2003. But nations such as Thailand and Singapore are warning that the high level of oil prices is slowing growth and could continue to do so in 2005.

What may be more important to the outlook is how the foreign trade sector influences inflationary trends in the U.S. Already, global demand for commodities has pushed up prices of raw materials. Even excluding oil, import prices of industrial supplies are up 16.3% in the year ended in August. U.S. producers have not been able

to pass along these price hikes to their customers. Producer prices for finished goods, excluding food and energy, were up only 1.5% in the same time period.

In addition, slowing demand elsewhere in the world means foreign producers will want to gain further market share in the U.S., one of the few vibrant economies right

BUSINESS BORROWING TURNS UP—FINALLY



now. Already, foreign companies are keeping their prices low, even with the weaker dollar. The latest import data show prices of imported consumer goods, excluding cars, up a tiny 0.6% in the year ended in August, while capital goods prices have fallen by 1.5%.

Low inflation, of course, will allow the Fed to maintain its measured approach to rate hikes. Equally important, it should keep bond yields at relatively low levels. Attractive financing is just another reason to expect a rebound in growth in the second half. ■

JAPAN

A Dip, Not a Collapse

THE DOWNWARD REVISION to Japan's second-quarter growth rate has raised questions about the economy's recovery. But other data argue against another downturn.

Real gross domestic product grew at an annual rate of just 1.3% in the spring, down from the original 1.7% estimate—and far below the 3.5% rate to which economists expected the figure would be revised. Weaker exports, especially to the major markets of the U.S. and China, was one reason for the slowdown. Monthly exports kept falling in July, suggesting that third-quarter data will also be soft. Weak exports are hurting factory production. Industrial output in July was unchanged from June's level.

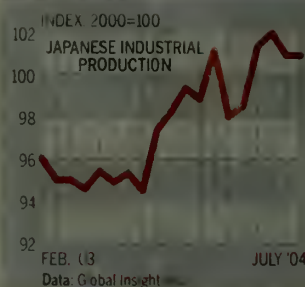
The yen and the Nikkei 225 stock average fell on the GDP news, but traders seemed to be ignoring the favorable numbers in the report. First, one reason for the downward GDP revision was a drop in inventories. And part of that reflected a jump in sales of air conditioners during an unusual heat wave in Japan—a sign of firming domestic spending. Also, business investment rose 4.9%, instead of being flat as was first thought. That upward revision dovetails with the optimistic results of the Ministry of Finance's latest corporate survey. Sales, profits, and profit margins all rose in the second quarter. Plus, the banking system continues to improve slowly,

providing more credit to companies. And with the U.S. slowdown now over, American demand for Japanese goods is sure to rebound in the second half.

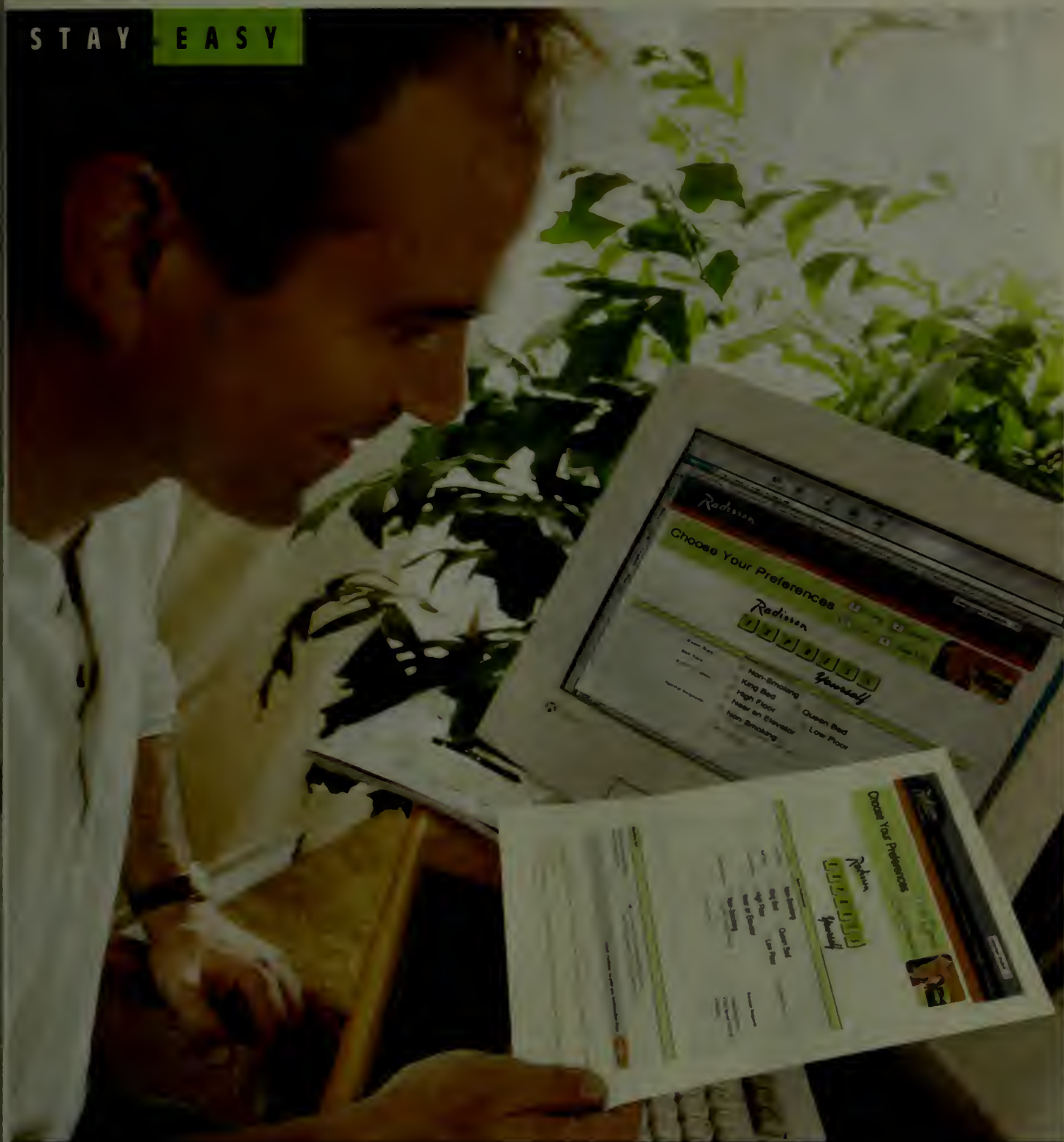
For the consumer sector, confidence is gaining ground, and the labor markets are slowly mending. Household income has stagnated, but with consumer prices dropping, household buying power is gaining.

Given such positive signs, it's no surprise the Japanese government is sticking with its forecast that the economy will grow 3.5% this fiscal year, which ends in March, 2005. And the Bank of Japan maintained a confident stance in its September monthly economic report. The BOJ stated: "Japan's economy is expected to continue to recover, gathering stronger momentum." So while the second-quarter GDP report certainly was disappointing, it seems too early to rethink Japan's recovery. ■

INDUSTRIAL ACTIVITY STAYS AT A HIGH LEVEL



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News Analysis & Commentary

SO

6



ILLINOIS Running for state Supreme Court, Judge Maag is in a brawl with opponent Judge Karmeier

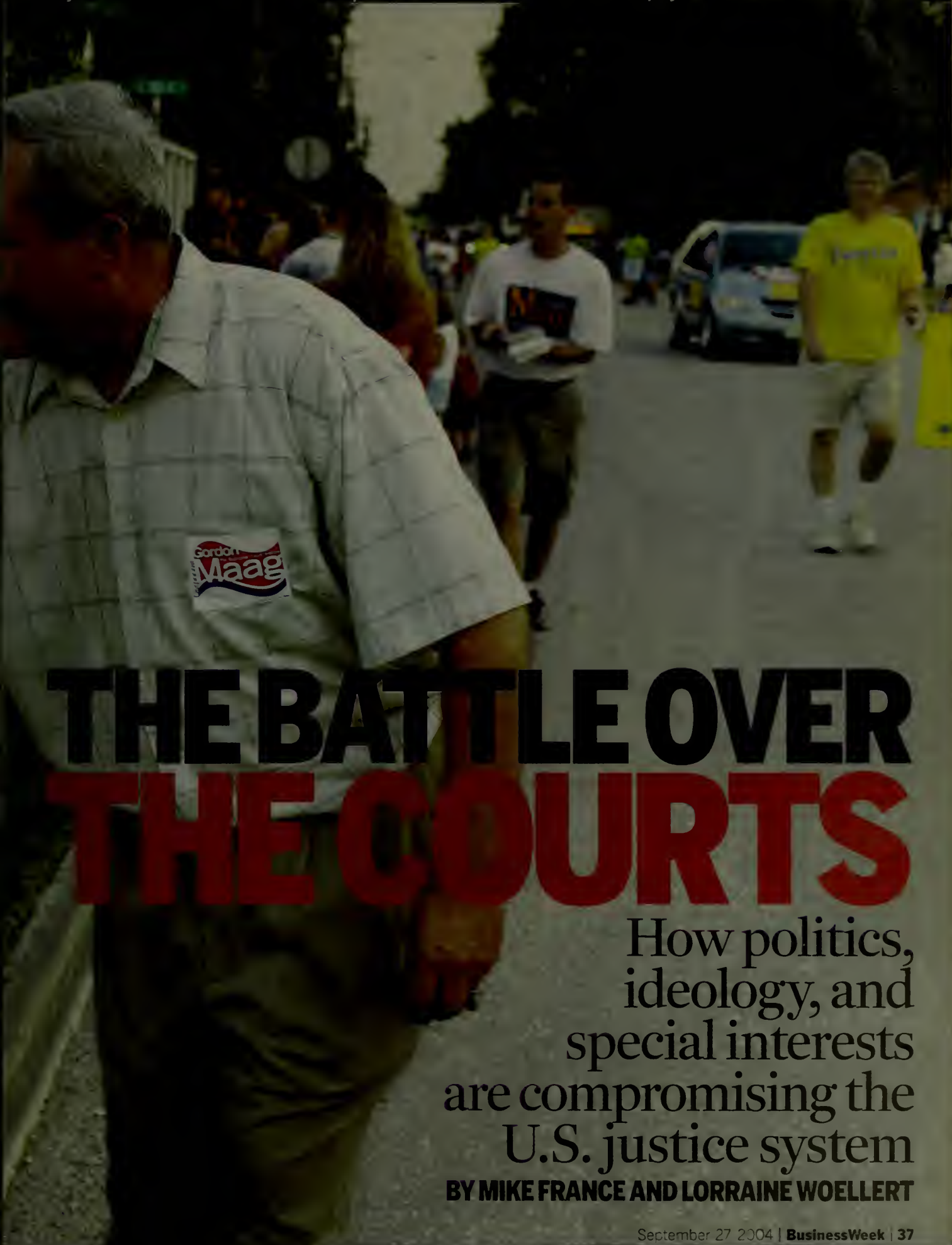
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THE BATTLE OVER THE COURTS

How politics,
ideology, and
special interests
are compromising the
U.S. justice system

BY MIKE FRANCE AND LORRAINE WOELLERT

LIKE PRIESTS, RABBIS, AND MULLAHS, judges go to work in robes. Their long black gowns are intended to convey the prestige, seriousness, and scholarliness of their calling. This message is reinforced by everything that surrounds them: the Lady Justice statues, the classic Greek revival courthouses, the people calling them "Your Honor." When you get right down to it, all of these trappings are designed to build faith in the core ideals of the American judiciary: that judges are fair, objective, principled, and nonpartisan.

That's the theory. For a dose of reality, go to the Green Grill in Centralia, Ill., where Gordon E. Maag is telling a dozen or so people why he should be elected to the state's Supreme Court. Over a dinner of fried catfish and Budweiser longnecks, the state appeals court judge lets listeners know that he isn't necessarily neutral about every issue, declaring that he's both pro-gun and anti-abortion. Maag and opponent Lloyd A. Karmeier, who holds a slightly lower-ranking seat, are locked in one of the ugliest judicial races in U.S. history. In May, someone rummaged through the Karmeier campaign's trash, digging up, among other things, campaign thank-you notes written inappropriately on official state letterhead. After the papers were delivered anonymously to the local press, Karmeier's backers responded with radio ads featuring two garbage men slamming Maag. "Judge Gordon Maag's supporters have literally taken his opponent's trash," the ad says. "That kind of dirty politics makes us garbage men seem clean."

Bitter Polarization

THIS KIND OF BEHAVIOR is hardly confined to rural Illinois. In the 38 states where judges are elected, as opposed to appointed, it is becoming increasingly routine for judicial candidates to run attack ads, fill out questionnaires detailing their beliefs, and hit up big donors on the phone—all things that were once considered beneath the dignity of the office. The process of installing federal judges, meanwhile, has become a tawdry affair. Liberals and conservatives bash one another with distorted accusations of racism, sexism, and religious intolerance. And last year, marking a new low point, Republican staffers for the Senate Judiciary Committee secretly infiltrated the computer files of their Democratic counterparts and reviewed thousands of confidential strategy documents.

The bottom line is that the same bitter polarization that has poisoned Presidential and congressional politics is starting to seep into the one branch of government that is supposed to be immune from it. Disregarding the unique professional culture of the judiciary, which has traditionally been valued across the ideological spectrum, special interests are increasingly turning to the courts to advance goals they can't win legislatively. So the U.S. Chamber of Commerce, frustrated in its attempts to pass meaningful state or federal tort reform, has spent an estimated \$50 million on judicial races since 1998, while plaintiffs' lawyers fight back with multimillion-dollar war chests of their own. Parallel battles rage between groups fighting over issues from gay marriage to abortion to medical malpractice reform.

All the crossfire is driving away potential

judges, making the partisan credentials of nominees more important than intellectual heft, putting pressure on jurists to favor contributors, eroding public respect for the bench, and little by little diminishing the ability of the courts to fulfill their constitutional role as a check on the power of the elective branches. It is a measure of how bad things have become that even the usually reticent American Bar Assn., the attorney trade group that has a history of shying away from controversial legal reform, is starting to worry about the problem. "We hope the major parties will agree to focus on a discussion of issues and not resort to name-calling and finger-pointing," says Dennis W. Archer, former mayor of Detroit and immediate past president of the ABA. "It undermines our system of justice."

The acrimony will only intensify when the next Supreme Court justice retires. Although the issue has received little attention so far in this year's Presidential campaign, the winner could be in a position to fill as many as four seats. That puts some of the most explosive policy issues in contemporary America up for grabs in this year's election. If the conservative wing of the court, led by Justices William H. Rehnquist, Antonin Scalia, and Clarence Thomas, gains one vote, it's entirely plausible that affirmative action could be outlawed, states could further limit the availability of abortion, and the new McCain-Feingold campaign-finance restrictions could be overturned. On the other hand, if a new liberal justice joins Ruth Bader Ginsburg and Stephen G. Breyer, it would probably become harder to impose the death penalty, and some environmental regulation could be strengthened. So no matter who wins the White House, it seems inevitable that the national mall in Washington will be hosting some massive protest marches over the next few years by one side or the other.

Of course, the courts have never been entirely divorced from politics. The reason so many states allow voters to select judges after all, is to ensure that judges are, at some level, held publicly accountable for their rulings. Supreme Court confirmation battles have been raging since 1795, when the Senate rejected George Washington's bid to name John Rutledge to be Chief Justice of the Supreme Court. And the people who are appointed to be judges, on the federal courts and in states without elections, are usually politically connected. Sometimes they're even politicians. Supreme Court Justice Sandra Day O'Connor was a state senator in Arizona from 1969 to 1975.

So the hallowed ideal—that judges are cloistered legal technicians, above the rough-and-tumble of politics—has never really existed. "When I started practicing law in Chicago [in 1952], the idea of an independent state court judge was almost impossible to imagine," recalls Abner J. Mikva, a former federal appeals court judge, congressman, and White House counsel. "It was a patronage operation, and you became a judge by kowtowing to the powers that be. It was not at all unusual for police captains to call a judge and tell him how to rule on a case."

But while politics has always played a role in the courts, it has never been as influential as it is today. In a poll of 894 elected judges conducted in 2001 and 2002 by Justice at Stake Campaign, a nonpartisan watchdog group in Washington, 48% felt a "great deal" of pressure to raise money during election years. Asked how much influence contributions had on their decisions, 4% said "a great deal of influence," 22% said "some influence," and 20% said "just a little influence." Those statistics should scare anybody who has

THE STAT

\$50
million

Estimated amount of money business groups have spent on state judicial elections since 1998

Data: BusinessWeek

Punch, Counterpunch

The roots of contemporary strife over the federal judiciary date back nearly five decades

ERA OF JUDICIAL ACTIVISM 1953-1980

After taking the reins as Chief Justice of the Supreme Court, Earl Warren (right) expands the rights of minorities and of accused criminals in landmark cases such as *Brown v. Board of Education* and *U.S. v. Miranda*. Under successor Warren E. Burger, the High Court continues to anger conservatives with controversial opinions such as *Roe v. Wade*.

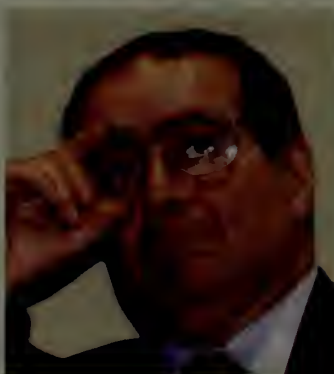


1957 Central High School, Little Rock, Ark.



REPUBLICAN ROLLBACK 1981-1986

Convinced that the courts have gone too far, President Ronald Reagan (left) starts a campaign to nominate conservative judges who will roll back Warren- and Burger-era precedents such as banning school prayer, encouraging affirmative action, and tolerating abortion. He nominates Sandra Day O'Connor to the Supreme Court in 1981 and Antonin Scalia (right) in 1986.



PAYBACK TIME 1993-2000

Bill Clinton's capture of the White House gives conservatives an opportunity to avenge the Bork and Thomas episodes. In an unprecedented effort to block the nomination of liberal justices, Republican Senators use a wide variety of tactics to stall more than 50 of Clinton's appeals-court nominees. Vacancies on the federal judiciary approach crisis levels.

"BORKING" BECOMES A VERB 1987-1991

The term is coined when Democratic senators torpedo the nomination of Reagan nominee Robert H. Bork (right) on grounds of extreme conservatism. Things get uglier in 1991, when the Dems launch an unsuccessful attempt to block the nomination of Clarence Thomas, airing accusations of sexual harassment and use of pornography.



ESCALATION 2001-2004

Accusing George W. Bush of nominating excessively conservative judges, the Democrats copy Republican tactics and invent some new ones. One strategy: The use of filibusters to kill the confirmation of some appeals court candidates deemed too ideological.

THE COMING VACANCY WARS 2004-?

No U.S. Supreme Court Justice has retired in more than a decade. So the next President could get to nominate as many as four Justices—enough to tilt explosive issues such as abortion (left), affirmative action, campaign-finance reform, and gay marriage (below).



The Escalating Battle Over State Courts

In the 38 states where judges are elected, once-sleepy judicial campaigns have become hardball partisan brawls

THE ISSUES Although they aren't as prominent as federal courts, state courts handle many of the cases that matter most to business, including product-liability suits, contract disputes, and consumer class actions.

THE PLAYERS Many state court races wind up as battles between Corporate America and plaintiffs' attorneys. Often the U.S. Chamber of Commerce and its local affiliates face off against the Association of Trial Lawyers of America, which has its own web of local chapters.

THE TACTICS Television advertising used to be unheard-of in state judicial campaigns. Now it's reaching record levels, with candidates and allied interest groups ignoring traditions of judicial restraint and bashing one another with negative ads.

THE LITMUS TESTS A little-publicized 2002 U.S. Supreme Court decision allows special interests to ask judicial candidates their views on controversial issues they might hear on the bench. So business groups quiz aspirants about their take on class actions, while social-issue activists pin down their positions on abortion.

THE MONEY To win in hotly contested states, some judicial candidates are building multimillion dollar war chests—often from people who might well appear in their courtrooms. Although precise figures are hard to tally, this year's races figure to be the most expensive ever.

case pending before these judges because the right answer is supposed to be "no influence at all," which garnered a mere 36%. The moral in these states is clear: It pays to hire a lawyer who has donated to your judge's campaign.

This isn't a problem just in a few places where court elections have become circuses. As the judiciary becomes politicized, lawmakers are more willing than ever to criticize judges for controversial decisions. Although federal judges are given life tenure to help them ignore these types of pressures, the static isn't always so easy to tune out. These days, ambitious district court judges who want to be elevated to appellate seats are watching their words more closely, steering clear of controversy, and retreating from the intellectual life of the profession. "The best way a judge can get nominated and confirmed is to have as little a paper record as possible," says Mikva. "Judges aren't writing as many law review articles, and their decisions are much narrower than they used to be."

One by one, many of the special unwritten traditions of civility and nonpartisanship that give the judiciary its moral authority are starting to erode. For instance, over the past four years, the White House and Senate have cast aside many of the informal rules that once governed the judicial confirmation process. President Bush has broken with his predecessors and won't consult with Democratic leadership on potential nominees. A custom that judicial nominees win at least one vote from the minority party has been discarded. And the Democrats are making unprecedented use of its filibuster



ILLINOIS AD: A business group warns that legal sharks are circling around state courts

power to block controversial Bush candida

Meanwhile, the combatants in the judicial v are slowly but surely enlarging the battle zone new states, lower courts, and other parts of the dicial selection process. TV ads were unheard-o state judicial races until about a decade ago. year, for the first time ever, spots are becoming o mon even in primaries. Big money is at stake these seemingly small-time elections. In Illin where one court recently handed down a \$10.1 lion damage award against tobacco giant Pl Morris, the Magg-Karmeier race has become a rogate for the furious national debate c tort reform. In fact, both candidates complain

they do not have control over some of t more fanatical supporters. "This is not a litical race, but we're being forced into politics of it," says Karmeier, the pro-b ness Republican.

The force driving many of these char is the same one that has played such a rosive role in America's broader polit culture: special interest groups. Incre ingly, they have come to view the judic as something to be gamed and capture just like Congress or the State House. The polit patronage that once existed in Mayor Richar Daley's Chicago is being replaced by a new fort interest-group patronage. The list of organizati that have jumped into America's judicial wa long and growing. Generally, they fall into broad categories.

In one, partisans battle over tort reform. The Chamber of Commerce; big companies such Home Depot, Wal-Mart Stores, and American ternational Group; and some small businesses in one camp. Plaintiffs' law firms and the Asso

tion of Trial Lawyers of America make up the other. These sides focus largely on state judges, who hear the majority of big product-liability and consumer-protection cases that m Wall Street shudder. For the past decade or so momentum been on the side of the business community, which helped incumbents in Alabama, Mississippi, and North Carolina 2000. This year the Chamber will be active in about half the tion's court races. "We've declared war on judges who aren't ing their duty," says Bernard Marcus, co-founder of Home De Inc., who has worked closely with the Chamber.

Money Soaring

THE OTHER BROAD GROUP focuses on social controver such as abortion, affirmation action, and gay marriage. Lir up on the Right are the Christian Coalition, Family Reser Council, the American Conservative Union, and the Commi for Justice. Their ideological opponents include Alliance for tice, a broad coalition of women's, labor, environmental, civil rights groups, and groups such as People for the Ameri Way. When Republican and Democratic senators ambush co candidates with unsavory biographical details, often on these groups has done the research.

The amount of special interest money pouring into jud battles is soaring—though it is impossible to get a complete ture of who's contributing what at either the state or federal

Unlike politicians, judges are supposed to be impartial. They represent the law itself—their job is to enforce principles and precedents regardless of the popularity of the outcome

According to the Brennan Center for Justice, a judicial watchdog group based at New York University School of Law, candidates for the highest courts in 20 states raised \$45.6 million in 2000, a 61% rise from two years earlier. No comprehensive spending studies have been undertaken since, but based on early advertising “it’s not rash to predict we’re going to see record numbers this year,” says Brennan Center Director Debra Goldberg. “It’s just through the roof.”

Above and beyond their financial contributions, special interests are also shaping the debate about who could be a judge. This is especially true in the states, where a little-publicized 2002 Supreme Court decision is shaking up the old rules of judicial campaigning. In *Republican Party of Minnesota v. White*, the court overturned a state law that forbade candidates on the stump from taking positions on controversial issues that they might be asked to consider on the bench. Writing for a 5-4 majority, Scalia reasoned that the rule violated the free-expression rights of would-be judges.

By making it easier for candidates to comment on policy issues, the *White* decision gives aspirants the ability to send signals to special interests about how they would rule in particular types of cases. That, in turn, is prompting interest groups to elicit candidates’ views on such hot-button issues—and use the information to decide who gets money.

The corporate-backed Illinois Civil Justice League, for instance, sent a questionnaire to 11 judicial candidates in the state this year asking them 12 multipart questions about their views on everything from class-action suits to the constitutionality of punitive damages. In Alabama, the League of Christian Voters is asking state supreme court candidates to provide written answers to 10 questions, including whether they are born-again Christians, go to church, and define marriage as a union between one man and one woman.” In Georgia, the Christian Coalition asks candidates whether they agree with the majority’s opinion or the dissent in such controversial cases as the U.S. Supreme Court’s 2003 gay-rights decision *Lawrence v. Texas*.

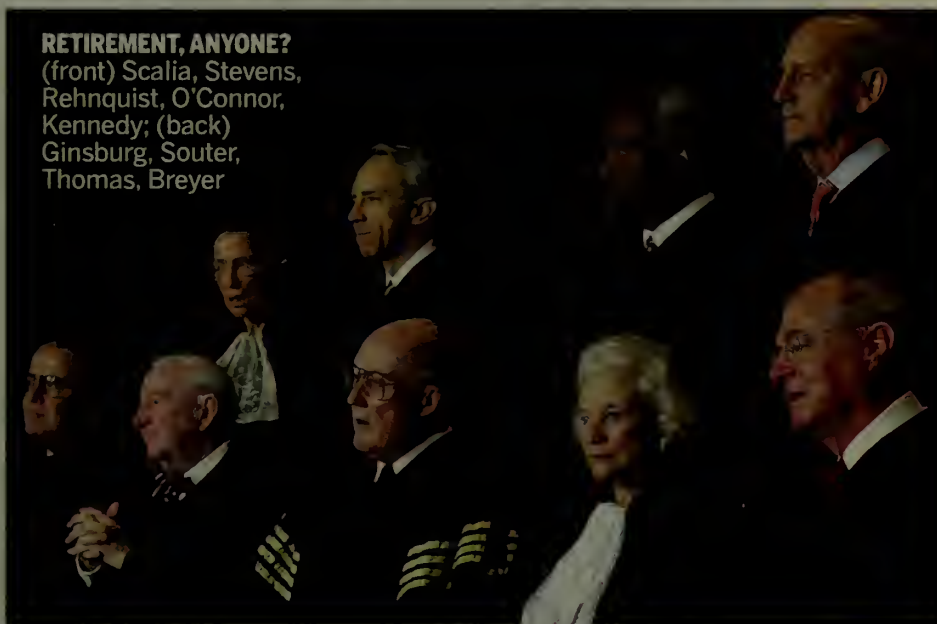
What’s so bad about elected judges telling the public where they stand? If candidates for president, the Senate, Congress, and state offices do it, why can’t judges? Because, according to critics of the *White* decision, judges aren’t meant to be politicians. Unlike their counterparts in the political branches, whose job is to advance the interests of those who vote for them, judges do not represent anybody. Their job is to represent the law it-

self—to follow the principles laid out in cases and statutes regardless of the popularity of the outcomes.

So when judges declare their positions on issues before they assume the bench, there is a danger that those commitments will sway their decisionmaking and prevent litigants from receiving a fair hearing. “When a judicial candidate promises to rule a certain way on an issue that may later reach the courts, the potential for due process violations is grave,” wrote Justice Ginsburg in dissent in *White*. This logic explains, in large part, why almost no

RETIREMENT, ANYONE?

(front) Scalia, Stevens, Rehnquist, O’Connor, Kennedy; (back) Ginsburg, Souter, Thomas, Breyer



Turning Point

The next President could get a chance to nominate as many as four Supreme Court justices—enough to tilt some of America’s most controversial legal issues:

ABORTION If the conservative wing of the court gains one vote, it could prevent states from allowing so-called partial-birth abortions. With two more votes, it might be able to overturn *Roe v. Wade*.

AFFIRMATIVE ACTION The notion that race can be used as a factor in college admissions and hiring decisions rests on a narrow majority. One more conservative vote and affirmative action could be dead.

BUSINESS REGULATION The Clean Air Act and the Endangered Species Act, two of Corporate America’s least favorite laws, could be weakened with the addition of another conservative justice.

CAMPAIGN-FINANCE REFORM The High Court upheld the McCain-Feingold election-reform bill by just one vote, with conservatives in the minority. If they gain power, the law could face renewed attack.

DEATH PENALTY One of the few areas where the addition of a liberal justice or two could make a big difference. An additional vote on the left wing of the court would probably make it harder for states to execute minors and incompetents.

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The extreme amount of big money in this year's judicial elections will only reduce public trust in the courts," says Senator John McCain

other country in the world allows judicial elections.

Alarmed at what's happening in the states, the ABA is pushing for publicly financed elections. This year, North Carolina became the first state to fully fund judicial campaigns. Ohio, Michigan, and Wisconsin are investigating ways to make private contributions more transparent. Several state bar associations are creating bipartisan watchdog panels that chastise candidates who cross the line with misleading ads, overtly partisan rhetoric, or positions that cast doubt on their ability to rule impartially. On Aug. 24, the Illinois State Bar Assn. said it will begin monitoring the Karmeier and Maag campaigns in an effort to bring civility to the race. A prominent new recruit to the state judicial election-reform bandwagon is Senator John McCain (R-Ariz.), who told *BusinessWeek* that he worries that "the extreme amount of big money in this year's judicial elections will only reduce public trust in the courts."

So some restraint may be coming at the state level. But in the federal arena, belligerents on both sides are escalating their brinksmanship. The central image in a liberal ad opposing federal appeals court nominee Charles W. Pickering, who has support from many Democrats and prominent blacks in his home state of Mississippi, is a group of Klansmen surrounding a fiery cross—because he once reduced the jail sentence of a cross-burner.

And things are coming to a head in the Senate, where Democrats have relied on filibusters to block right-wing candidates for appeals court positions. In the coming months, Senate Majority Leader Bill Frist (R-Tenn.), with the backing of the White House, plans to make a new rule forever banning filibusters of judicial nominees—a hardball parliamentary tactic. But if he exercises what pols are calling the "nuclear option," Democrats have threatened to bring all business in the Senate to a halt.

Meanwhile, in an attempt to outflank judges who may one day write decisions encouraging gay marriage, some GOP lawmakers are trying to prevent federal courts from considering the issue at all—a creative use of legislative power, called court stripping, that could provoke a furious Constitutional battle. Led by Majority Leader Tom DeLay of Texas, the House voted on July 22 to limit the jurisdiction of federal courts to hear cases involving gay weddings. The GOP is also pondering using this strategy in cases involving abortion, obesity suits, and the Pledge of Allegiance.

Funding Crunch

IN FACT, CONGRESS HAS GROWN quite fond of telling judges how to behave. Representative Tom Feeney (R-Fla.) doesn't like the way U.S. courts are increasingly referring to foreign legal authority—as the Supreme Court did in *Lawrence* when it cited European courts when overturning a Texas anti-sodomy law. So in March, Feeney introduced a nonbinding resolution protesting the use of overseas legal precedents. In

August, House Republicans announced a new task force to scour the output of federal judges for evidence of what they call "judicial abuse." According to Stephen P. Burbank, professor for the administration of justice at the University of Pennsylvania Law School and head of a task force on judicial independence at the American Judicature Society, "the relationship between the federal courts and the Congress is the most poisonous I've seen it in 30 or 40 years."

One byproduct of that tension: a clampdown on court funding by Congress. Since 1990 the nation's 160 federal appellate court judges have witnessed a 40% rise in the number of cases considered—with no increase in funding for more judges. Although the Administrative Office of the U.S. Courts has asked Congress to fund 54 new judgeships, it's unlikely to get any more cash. So courts across the country are shutting their doors one day a week, putting trials on hold, and deferring payments

to court-appointed attorneys. And pay for federal district judges is \$158,100—several hundred thousand dollars a year less than many could make in private practice. When New York City-based federal judge John S. Martin Jr. left the bench in 2003, he cited low pay as one of the key reasons. "The thing that really galled me was that I was making \$150,000 less than Major League Baseball umpires," says Martin.

The crucial question isn't whether there is going to be an exodus of federal judges but whether politics is diminishing the ability of the courts to play their constitutional role. Under the U.S. system of separate powers, the judiciary is charged with ensuring that the principles embedded in the Constitution, statutes, and common law are honored regardless of what the majority thinks.

Nan Aron, president of the left-leaning Alliance for Justice, fears politics may prevent judges from fulfilling this critical duty. "The courts in this country have really been the only forum to provide redress to people of color, women, environmentalists, consumers," she says.

Conservatives are also concerned about the impact of political pressure on the courts. But they fear that liberals and tort lawyers are pushing too far toward the creation of new rights that were never envisioned by the Founding Fathers. "What Republicans think endangers the judiciary are litmus tests applied by the Democrats," says C. Boyden Gray, founder of the Committee for Justice. "They will only appoint judges who are totally pro-choice on abortion and anti-choice on schools."

So here's where things stand: Conservatives blame liberals for the current debauched state of judicial politics, and liberals fault conservatives. The truth is that both sides are culpable—and seem to be racing to see who can capture lower ground. So long as the two sides remain locked in partisan warfare and the country's overall civic culture continues to degenerate into ever more antagonism, there seems little reason to hope that politics will soon loosen its tightening grip on the judiciary.

—With Brian Grow in Atlanta

THE STAT

46%

Percentage of elected judges who say campaign contributions influence their decisions

Data: Justice At Stake

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MORTGAGES

JUST HOW RISKY ARE FANNIE AND FREDDIE?

Not very, says a new report. But it probably won't sway the mortgage giants' critics

FOR YEARS LARGE commercial banks have urged Congress to rein in the galloping growth of mortgage-finance giant Fannie Mae and its smaller cousin, Freddie Mac. So far the two government-chartered, shareholder-owned companies have fought off efforts to restrain them. But the "too big, too risky" refrain grew louder in the past year as Federal Reserve Chairman Alan Greenspan and Treasury Secretary John W. Snow added their voices to the chorus. They advised Congress to put Fannie and Freddie under Treasury's oversight and let regulators set capital standards—a backdoor way to limit the housing giants' growth.

Not everyone is as worried as Greenspan and Snow—particularly R. Glenn Hubbard, President George W. Bush's former chief economist. In a 33-page study that Fannie Mae commissioned and made available to *BusinessWeek* before publication, Hubbard, who now heads the Columbia Business School, argues that Fannie is no riskier than the 10 largest commercial banks or their holding companies. Hubbard also concludes that Fannie's capital reserve—the cushion that financial institutions need in case of emergency—is adequate.

Why does this matter? Fannie Chairman and CEO Franklin D. Raines will use the report to rebut critics who charge that Fannie's low borrowing costs represent an implicit federal subsidy created by debtholders' confidence that the government will rescue them in a financial crisis. Hubbard's work will bolster Raines' argument that Fannie has a cost advantage because it's low-risk. In the study's foreword, Raines writes that Hubbard "confirms the



One Measure

Why Bush's former chief economist, R. Glenn Hubbard, believes Fannie is no riskier than a bank:

LOWER CREDIT LOSSES

For the past 13 years, Fannie's losses from bad credit are far below those of large commercial banks

LESS EARNINGS

VOLATILITY Despite some ups and downs caused by accounting-rule changes, Fannie's earnings as a percent of assets are less volatile than those of big banks

HIGHER ASSET QUALITY

Fannie's portfolio of home mortgages has better collateral than banks' business and consumer loans

LESS RISK OF DEFAULT

Five different tests show Fannie's chances of default to be lower than or equal to those of large banks

Data: The Relative Risk of Fannie Mae by R. Glenn Hubbard

low-risk nature of Fannie Mae's business but also...indicates a fundamental flaw in studies that purport to quantify an 'implicit subsidy' to the company." Hubbard says: "That's Frank Raines's view."

However it's spun, the study is the first real measure of Fannie's risk to its bond-

holders and the government. It may well intensify the debate over Fannie's future. Treasury and Fed spokesmen refused to comment on the paper. But other experts say Hubbard's quantitative approach fails to consider the everyday stresses and strains Fannie faces. "This is a theoretical academic exercise that doesn't capture Fannie's real-world risks," says Michael T. DeStefano, managing director for financial institutions at Standard & Poor's.

In some ways, Hubbard's approach is like the mathematical arguments used by Long Term Capital Management to claim that its risks were properly hedged, right up to its 1998 collapse. But while Hubbard concedes that his analysis is strictly quan-

titative, his model considers perfect storm scenarios, including a one-year jump in rates to 11%, a 5% drop in home prices nationwide, and up to a 25% fall in regional housing. And unlike LTCM's illiquid assets, Fannie holds easily saleable home mortgages.

Still, Hubbard does not consider scenarios that can't be quantified because they have never happened, such as the systemic risk of a rapid interest-rate increase that causes housing prices to decline, touching off a series of financial-institution failures. In response, Hubbard says that risk studies aren't usually based on cataclysms for which a bank would have to hold infinite amounts of capital. "You're not typically looking for events that aren't in the record," he says. Hubbard's analysis rests on econometric models that crunch factors including the quality of Fannie's assets, its exposure to sudden

changes in interest rates, the volatility of its earnings, and the probability of default. He concludes that, if Fannie failed, the government and bondholders could expect to lose \$90 billion. That's just 8.9% of Fannie's \$1 trillion in assets, compared with the 22.3% of assets that would be lost if the

typical commercial bank failed. Neither Hubbard (who also writes a column for *BusinessWeek*) nor Fannie would reveal how much he was paid for the analysis.

But Hubbard's study isn't likely to silence Fannie's critics. One reason is that Hubbard views Fannie's high level of concentration—90% of its balance sheet is mortgage-based—as a plus, since losses on mortgages have been historically low. But S&P's DeStefano worries about the lack of diversification. That means Fannie has no other business to rely on if housing deteriorates.

DeStefano, one of few experts who has read the study, also argues that the bond market accepts a lower yield from Fannie because “everybody looks at Fannie as though it's part of the government,” and no study can erase that perceived link. If Fannie were to lose its implied government backing, borrowing costs would probably go up—if only because S&P would reconsider its triple A credit rating, he says. S&P, like *BusinessWeek*, is a unit of The McGraw-Hill Companies.

LEGAL LIMBO

ANOTHER ECONOMIST who read the study and is familiar with Fannie also takes issue with Raines's conclusion that Fannie's lower borrowing costs are due to its low-risk profile. Fannie's big advantage, he says, is its ability to act like a mini-Treasury: Unlike commercial rivals, it can issue debt securities quickly and at will, without having to register the debt with the Securities & Exchange Commission. Investors accept a lower rate on Fannie's debt because they know they'll always find a buyer. Fannie owes that liquidity to its quasi-governmental status, not to lower default risk, says this economist, who asked not to be identified.

One more problem: Hubbard doesn't mention the legal limbo Fannie's debtholders would be in if Fannie were to fail. Fannie's regulator, the Office of Federal Housing Enterprise Oversight, has no authority to act as a receiver and determine the order in which claimants would be paid. With no receiver, Fannie's debtholders might trigger panic selling.

What worries Greenspan and Snow is the risk of financial contagion based on unforeseeable events. They're also alarmed by Fannie's high debt: \$962 billion at the end of 2003. They and other critics aren't likely to be swayed when Raines asserts that Fannie's capital reserves are adequate. Hubbard may add a scholarly layer to the discussion, but he probably won't change many minds. ■

—By Paula Dwyer in Washington



THOMAS “When I hire someone, I know I have their future in my hands”

WORKPLACE

HEALTH INSURANCE: SMALL BIZ IS IN A BIND

Disproportionately hit by cost hikes, more are paring worker coverage—or ending it

FOR JANE V. THOMAS, THE raging national debate over the cost of health care hits close to home. As the insurance bill for her Laramie (Wyo.) company, Wyoming Analytical Laboratories Inc., climbed 10% this year, to more than \$5,000 a month—the latest in a series of double-digit hikes—she decided to stop offering coverage to her 15 eligible employees. Now the 64-year-old chemist, whose family was once hit with catastrophic illness, is haunted by the choice. “When I hire somebody, I know I have their future in my hands,” says Thomas. “It bothers me a lot.”

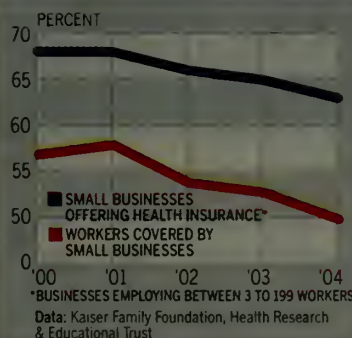
Even as President George W. Bush and Senator John F. Kerry ratchet up the rhetoric

over how best to fix health care, plenty of small-business owners are voting with their feet. While big and small companies alike are struggling with soaring health-care costs, the combination of a patchy economic recovery and ever-higher premiums are falling hard on companies too tiny to have clout with insurers. “It's a particular problem for small businesses,” says Karen Davis, president of the Commonwealth Fund, a

private foundation that tries to broaden health-care coverage. “Premiums are going up faster for them, but they get less for the premium dollar than big firms.”

As a result, hundreds of thousands of small companies are scaling back the coverage they offer to employees, boosting co-pays, or pulling

SIZE MATTERS



the plug on insurance altogether. And even when they continue to offer coverage, many employees are canceling policies because they can no longer afford their share of sharply higher premiums. According to a Sept. 9 report by the Henry J. Kaiser Family Foundation and the Health Research & Educational Trust, 63% of businesses with fewer than 200 employees now offer health benefits, down from 68% in 2001. Worse, just 50% of employees at small companies have coverage at work, vs. 57% three years ago.

The worrisome trend is stoking a decade-long debate: Should the federal government step in to help ease the burden on small businesses and their workers, an option favored by the Kerry camp? Or should small-business owners be allowed to pool their resources to buy coverage on the open market, the route preferred by many Republicans and small-business trade groups?

Rising health-care costs are squeezing just about everyone. For the fourth year in a row, health-insurance premiums in all employer plans climbed at a double-digit rate—11.2% on average this year, according to the Kaiser study. Driven by hikes in medical costs and a cyclical downturn among insurers, family coverage at work now averages \$9,950 a year, while coverage for singles has hit \$3,695. Many small firms have suffered even higher premium hikes because they can't self-insure as big outfits can, have little bargaining power with insurers, and employ fewer people over whom they can spread risk, says the Commonwealth Fund.

OUT IN THE COLD

HEALTH-CARE EXPERTS are especially troubled by the slide in coverage at small companies because a disproportionate number of Americans work for them. Nearly three-fourths of America's 45 million uninsured work at companies with fewer than 500 employees or are dependents of such workers, says the advocacy group Alliance for Health Reform.

For Bush and the National Federation of Business, the answer seems simple: Let small businesses band together in national groups to pool their risks and buy coverage, much as big companies do. Such association health plans (AHPs) ap-

peal to many small-business owners because they rely on market forces and seem to level the playing field between small firms and insurers. "That could help us lower our prices," says Steve L. Steinheimer, president of software consultant SSG Ltd. in Richardson, Tex., which expects its health-care costs to rise 27% next year.

But for many experts, AHPs offer false hope. They fear such plans would try to

monitored, and is financially secure. One idea, favored by Kerry, would open it to small and large businesses and individuals, effectively allowing them to benefit from the buying clout that a huge member base brings. To woo small business, Kerry would stabilize the rates with government subsidies, keeping them low even for outfits with high claims by chipping in government dollars. He would also offer a tax credit for small



SAN FRANCISCO
Siegel has had to raise co-pays for three years running

keep costs low by weeding out companies with more ill workers than average. Once free of such commonly state-mandated benefits as mental-health coverage, they say, insurers will offer fewer benefits. Critics also warn that many plans, in a bid to attract members, may not charge enough to cover costs and could eventually go broke. That's what happened in Kansas in the 1980s when AHP-like plans were permitted there. And some fear poor regulatory oversight since states would have no power over national AHPs. "If people see this as a silver bullet, they'll be sorely disappointed," says Michael Miller, director for health issues at Community Catalyst, a health-care policy group in Boston.

AHP opponents look to a plan that already serves 9 million federal employees and their dependents. The Federal Employees Health Benefits Program offers choices among some 200 private health plans across the country, is carefully

businesses to cover up to half the cost.

It wouldn't be cheap. Davis figures the Kerry reforms would cost some \$323 billion over 10 years. AHP advocates argue that they'd be better able to fashion plans with lower premiums once freed of government mandates. The federal plan "is too expensive for most employers," says Jamie Amaral, the NFIB's national director for health research and development.

Is there a solution to this mess? Given the rancorous tone in Washington these days, it may not come soon. With small businesses unable to agree on the best fix, the reality is that more and more will be forced to trim coverage. Gary Siegel, who runs San Francisco Auto Repair Center, has hiked co-pays for the past three years. He is "reconciled to the fact that the costs are just going to keep going up." That means more pain for everyone. ■

—By Joseph Weber in Chicago, with William C. Symonds in Boston, Louise Lee in San Mateo, Calif., and Stephanie Anderson Forest in Dallas



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COMMENTARY

BY RONALD GROVER

Eisner's Goofy Timetable

The Magic Kingdom needs a new CEO presto-change-o, not two years from now

MICHAEL EISNER must have figured he had put his troubles behind him. His Sept. 10 announcement of plans to step down as chief executive of Walt Disney Co. in late 2006 would give the 62-year-old mogul two years to rebuild Disney's fortunes and restore his own tarnished image. The schedule also would give Eisner a hand in picking his

successor. Not a bad move for a CEO who just months ago lost his post as chairman after 45% of shareholders voted against him at Disney's annual meeting.

But Eisner's waning days at Disney may not follow that happy script. Two more years at the helm won't fix what ails Disney. Dissident former board members Stanley Gold and Roy Disney, who spearheaded the earlier move to oust Eisner, have threatened to make more trouble if Eisner sticks around. They'll have plenty of support: Investors remain irate as the stock languishes, despite improved earnings. The ABC Network is a mess. And both Steve Jobs's Pixar Animation Studios and Harvey Weinstein's Miramax Studios want out of their Disney partnerships largely because of frayed relationships with Eisner. Says Sean Harrigan, president of the California Public Employees Retirement System and a longtime Eisner critic and Disney stakeholder: "It is not clear to us how a two-year lame duck CEO will benefit shareowners."

If only the board could see as clearly. Long criticized as yes-men to Disney's powerful CEO, board members face stark choices that will test their own credibility. Here are some ways they can win back investor support:

FIND A SUCCESSOR, AND FAST The board should ignore Eisner's schedule, plan an earlier departure, and begin a search for his replacement with or without Eisner's involvement. That doesn't mean Eisner's chosen successor, Disney President Robert Iger, shouldn't be considered. Though a strong No. 2, he has been tarred with ABC's lousy performance. To make the best choice, the board must hire an executive search firm and

cast a wide net. Former Disneyites such as Gap CEO Paul S. Pressler and eBay CEO Margaret C. Whitman are possibilities, as is News Corp President Peter Chernin. None of those top-flight outsiders will consider the job, however, if they think Eisner will continue to lurk for another 24 months.

That's not the only reason waiting until 2006 isn't an option. Disney could win back Pixar if it makes a decision by mid-2005, when Merrill Lynch analyst Jessica Reif-Cohen says Pixar needs to find a new distributor. And Iger's own contract expires in late 2005, meaning Disney might lose him as well by dithering.

STRENGTHEN THE BOARD Board chairman George J. Mitchell,

a brilliant strategist as Senate Majority Leader, is no business expert, and he was reluctantly elevated to the top job after Eisner's no-confidence vote. The board is looking for a 12th member. It should add someone with the chops to be chairman, and it should turn to a true outside board member, such as Clorox Co. Chairman Robert W. Matschullat, to head the search. Some shareholders see Mitchell as too closely allied with Eisner to feel confident he won't influence a Mitchell-run search. And pension-fund representatives, who have been promised a say in choosing the next member, should be consulted.

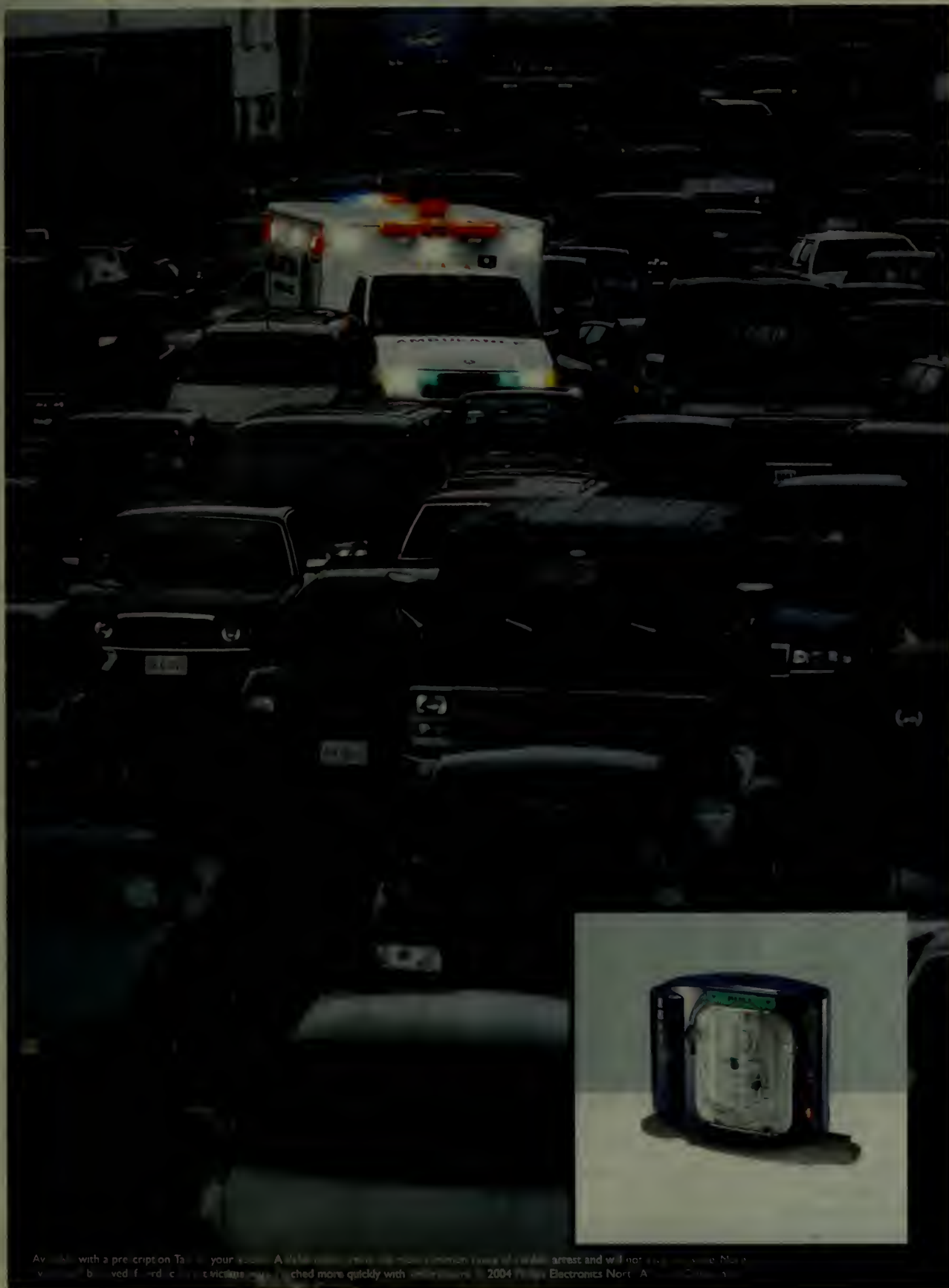
CUT EISNER'S BOARD TIES Exiting CEOs have sometimes helped their successors make the transition to the job. But at many companies, including Coca-Cola Co. and Xerox Corp., the arrangement has been problematic, particularly when the outgoing CEO dominated the company culture, as Eisner has Disney's. The risk that Eisner will remain could hurt the search for a strong candidate. That's why directors also must set a date for Eisner to leave the board once they name a successor.

The good news, says Patrick McGurn, senior vice-president of proxy consulting firm Institutional Shareholder Services, is that after the board "wasted a decade," the end is at least in sight. Still, two more years of boardroom intrigue, management uncertainty, and investor unhappiness is too much. Time for Mickey and Michael to shake hands and say so long. ■

—With Louis Lavelle in New York



A new chief might be able to lure Pixar back to the fold



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THE INTERNET

AMAZON JOINS THE SEARCH PARTY

A9.com is a feature-laden search tool. Now it needs to find itself a business model

WHEN AMAZON.COM Inc.'s highly anticipated search site, A9.com, launched on Sept. 14, the biggest surprise was what wasn't there. Sure, it has plenty of useful bells and whistles, such as the capability of keeping logs of every search and scanning the full text of thousands of books. But while clearly advancing the state of online search, A9 lacks what many expected to be its *raison d'être*: shopping help. There's no special way to search for products, on Amazon.com or anywhere else.

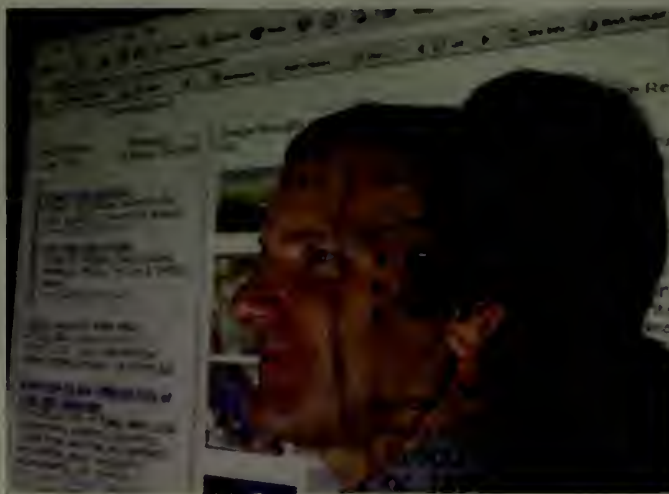
What seems to be a shortcoming, though, actually signals the e-commerce giant's even broader ambitions. Its one-year-old search unit—a wholly owned company it started in Palo Alto, Calif.—intends to go well beyond helping consumers find stuff to buy. A9 Chief Executive Udi Manber says he wants to help curb information overload by allowing people to organize the Web in a more personal way. "The goal is not to push stuff on you," says Manber. "We're looking at search from a very broad perspective."

In the process, A9 is aiming for the Holy Grail of the Internet business: to be the prime place for connecting people looking for just about anything—information, products, or services—with those who provide it. That position has proved lucrative for search king Google, Web portals Yahoo! and Microsoft's MSN, and online marketplace eBay. Manber insists it's too early to know how he'll make money from such a hub. For now,

A9 is simply taking a small cut of sponsored search results it runs from Google, whose search engine it uses for basic results. Ultimately, observers speculate that it could license technology to other companies, just as Amazon has rented out its Web site to outside merchants. A9 also could place buy buttons alongside search results that link to books or other products for sale on Amazon.

No matter what business

MR. INFORMATION
CEO Manber: A9 won't "push stuff"



Looking for Answers

Amazon's A9 online search unit faces big obstacles. Among them:

FINDING A BUSINESS MODEL A9 currently gets revenue from running Google's sponsored ads, but it will need to pursue more lucrative opportunities, such as linking search results to Amazon products.

AVOIDING GETTING STOMPED With more money, experience, and users, Google, Yahoo!, and other search sites and portals could best A9's innovations.

KEEPING IT SIMPLE A9 requires users to download a toolbar to use some of its search options. That may be expecting too much of many Web surfers.

model emerges, A9 puts Amazon on a collision course with most of the Web's major players—especially Google, which declined to comment. Nonetheless, says John Battelle, who writes Searchblog, a Web log about the online search world, "Google and everyone else involved in search are going to be watching this very closely."

Manber disavows any intention to knock Google off its perch—just as well because A9 faces serious obstacles. For one, Google and rivals like Yahoo and Ask Jeeves Inc., could copy A9's features if they prove popular. Moreover, A9 could butt heads with Google so hard that it has to create or buy its own search technology, a tall order. Says Jim Lanzone, a senior vice-president at Ask Jeeves: "Without owning the core search technology, it will be tough to compete with companies like Ask Jeeves, Google, and Yahoo."

GET YOUR FACTS IN ORDER

EVEN SO, A9 BOASTS a raft of intriguing features not seen on any other search site. A9's tools allow people not just to search

for information but to track and manage it as well. One column of the search page is a time-stamped history of every search a user has made—and every Web site they've ever visited. In addition, there's a diary feature which lets you attach notes to Web sites so you can remember later what was important. A test feature called Discover suggests sites you might like based on your browsing history and that of other people who made similar searches. And because all this is stored on Amazon's servers, it's available from any computer by signing in.

Amazon also is making it easy to target searches to special stores of information. Several years ago, for instance, it bought the Internet Movie Database (IMDb), a Web site full of data on movies and actors. Now, at A9.com, people can target searches to IMDb and others, such as Amazon's database of the texts of thousands of books—with more to come.

None of this is yet likely to give nightmares to the folks at Google, which earned \$79 million or \$700 million in sales in the second quarter alone. But it's a good bet that Amazon.com's little search engine will be making bigger waves before long. ■

—By Robert D. Hof in Palo Alto



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COMMENTARY

BY JIM KERSTETTER

PeopleSoft: Ease the Inevitable

Fighting Oracle's takeover bid made sense at first. Not anymore



CEO CONWAY
It's time to negotiate a good deal

FOR MORE THAN A YEAR, PeopleSoft Inc. CEO Craig Conway has battled to prevent Oracle Corp.'s Larry Ellison from grabbing his company in a hostile takeover. Now, Conway's spirited quest has absorbed a potentially fatal blow: On Sept. 9, U.S. District Court Judge Vaughn R. Walker ruled that the Justice Dept. had no grounds to block the acquisition.

While the European Community could still stop it, the legal case for halting this shotgun wedding is looking weaker by the day.

It's time for Conway to give up the fight. True, doing so will mark an ignominious defeat for a talented leader who helped turn PeopleSoft around in the late '90s. A takeover also will mean painful layoffs. But if Conway soldiers on, his company's prospects—already made worse by the protracted fight—will turn dire. Ellison, who badly needs PeopleSoft to shore up his sagging applications business, isn't going away. Says Addison L. "Tad" Piper, vice-chairman at investment firm Piper Jaffray Cos.: "Stretching this out hasn't helped anyone."

When Ellison first made his bid in June, 2003, it made sense for Conway to test his resolve. Over the years, PeopleSoft had built an enviable relationship with its corporate customers. What's more, the company had a reputation for being more innovative than Oracle in applications. Conway argued, not with-

out merit, that being taken over by Oracle, led by the famously abrasive Ellison, would undermine both of those strengths.

But that was then. PeopleSoft's business, troubled for two years, is crumbling. For a while customers kept the faith, but in recent months growing concerns about the takeover fight have eroded their confidence. What's more, corporate spending has not revived as strongly as projected. The combination means companies that are buying software these days are consolidating around fewer suppliers—and PeopleSoft isn't on the short list. While PeopleSoft has been forced to discount heavily to keep many customers

German giant SAP has emerged the big winner, with a 23% gain in U.S. software sales for the second quarter. PeopleSoft's second-quarter net income fell 69% from a year earlier, to \$10.98 million, while sales of \$647 million fell well short of analysts' expectations.

Still, Ellison badly needs PeopleSoft. Thanks to Oracle's strong database unit, fiscal first-quarter earnings jumped 16% to \$509 million, on sales of \$2.22 billion. But its application sales plunged 36%. Eager to get his hands on PeopleSoft's customers, Ellison has guaranteed to support its software for up to 10 years to ease their fears. That's better than PeopleSoft's existing maintenance contracts.

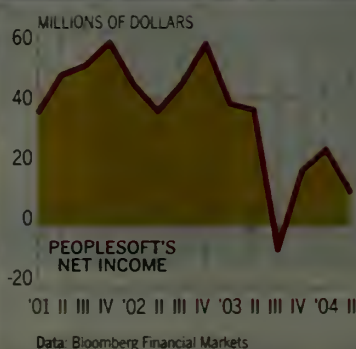
Oracle's bid has plenty of upside for investors, too. The cash offer of \$21 a share values PeopleSoft at \$7.7 billion, plenty for

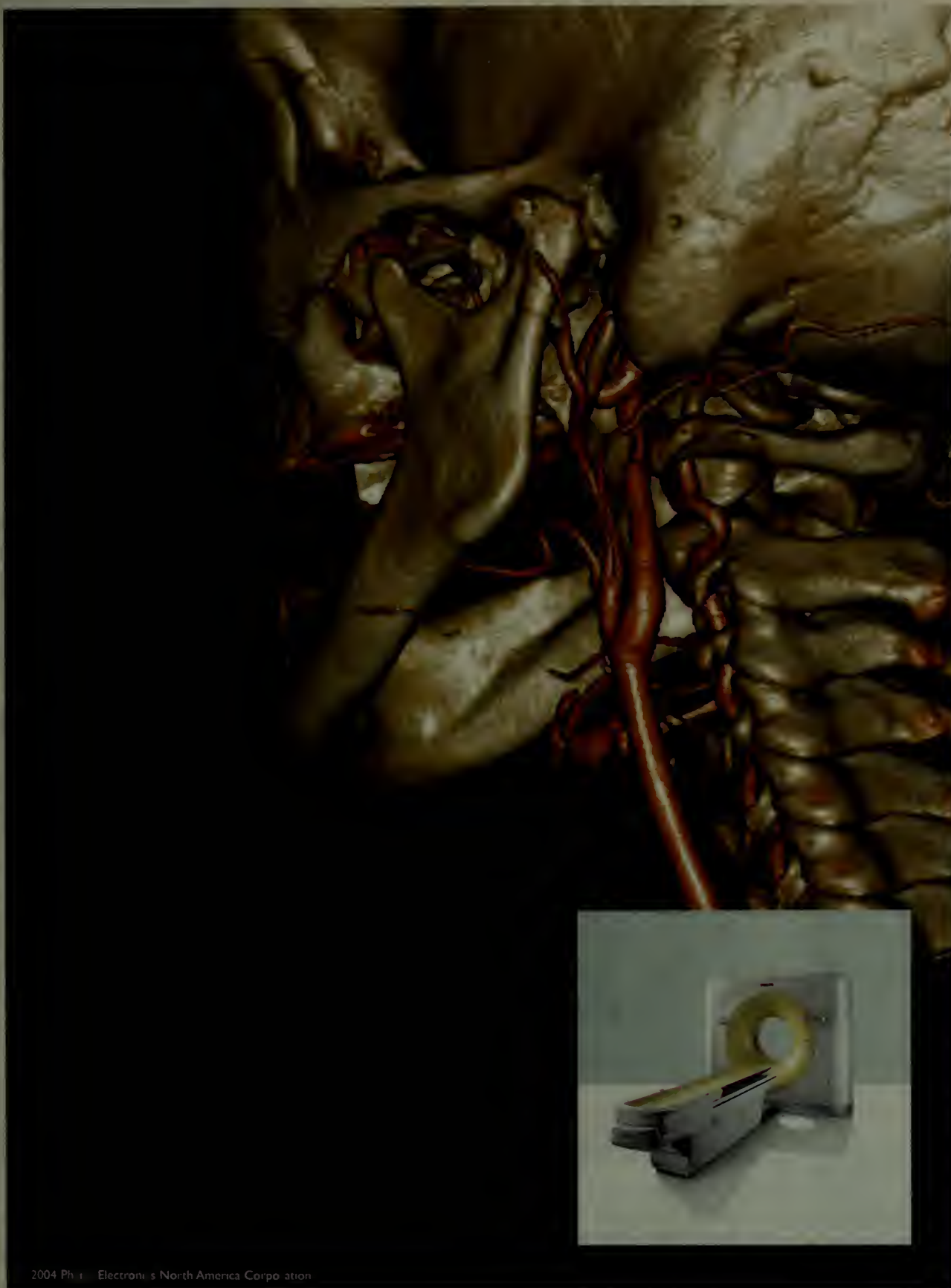
a company with just \$2.3 billion in yearly sales. The bid is also about 26 times PeopleSoft's earnings; big software deals usually don't go for more than 20 times earnings. PeopleSoft is now trading at about \$19, but only because a takeover appears probable. It is unlikely to get near \$21 on its own. Conway would do better negotiating the best price he can before its fortunes decline even further.

Why won't Conway give up? He's eager to protect his legacy. PeopleSoft's employee-empowerment plans and dedication to customer needs are widely admired. Analysts figure over half of the company's 12,000 employees will lose their jobs. And he still argues that PeopleSoft will make better software alone.

But consider one alternative scenario: Oracle launches a proxy fight and takes control of the board after another year of decline. Everyone at PeopleSoft would lose—shareholders, execs, and employees. That's not a fitting legacy for a leader who up to this point, has always done right by his company. ■

SOFTENING RETURNS





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News In Biz This Week

EDITED BY MONICA ROMAN

HEADLINER

MARTHA STEWART



CHILL FOR FIVE MONTHS

Although she's known more for her decorating abilities, Martha Stewart certainly knows her math. Faced with the prospect of five months in a minimum-security prison vs. another uncertain year while waiting to appeal a guilty verdict for lying to the government, the domestic diva opted for jail.

But Stewart's Sept. 15 decision is unlikely to have much impact on her struggling company, which has already moved to distance itself from its founder and is nurturing new properties that don't bear her name. The stock price of her company, **Martha Stewart Living Omnimedia**, rose 1%, to 11.26, on the news.

Stewart fought back tears after announcing that she has asked to start her five-month jail stint, and told reporters that she hoped to be back in her garden for spring planting. With diminishing ad sales and weaker circulation at her magazine, not to mention her popular TV show being on hiatus, a more critical task will be wooing back advertisers and fans.

—Diane Brady

YOU DESERVE A PAYOUT TODAY

McDonald's revitalized focus on its menu is paying dividends—literally. The hamburger giant said on Sept. 14 that it is hiking its annual payout to stockholders by 38%, to 55¢ a share. Including last year's 70% boost, McDonald's dividend has more than doubled in two years and now totals almost \$690 million in corporate payouts. Big Mac can easily afford it: The Oak Brook (Ill.)-based chain reported a week earlier that same-store sales rose 3.9% worldwide in August, the 16th month in a row of increases at stores open more than a year. Lifting sales: new premium products such as Chicken Selects—breaded strips of white-meat chicken—and a fourth entrée salad.

LOOK, TOUCH, BUT DON'T BUY



Call it the unstore. Not to be outdone by the stylish **Sony** and **Apple** stores, **Samsung** is opening a sleek 10,000-square-foot showcase for its consumer electronics in the new Time Warner Center in Manhattan on Sept. 23. But the space is so cool that there isn't a price tag in sight. Instead, Samsung wants to wow visitors with interactive kiosks, freebies, and the ability to play with consumer

electronics in a low-pressure environment where nothing is for sale. Visitors walk by two rows of videos flashing on 40-inch flat-screen TVs before entering modern rooms that highlight how Samsung's products work in the home, in the office, and on the go. The Korean giant is considering opening similar showcase stores in other cities.

A DRY SPELL FOR COKE

Where's the fizz? That's what **Coca-Cola** is trying to find out. On Sept. 15, the beverage giant warned Wall Street of weak second-half earnings. Disappointing sales in North America, higher costs in Germany, and wet weather in Europe were blamed by Chief Executive Officer E. Neville Isdell, who took over from Douglas Daft in June. **PepsiCo's** soft-drink sales, meanwhile, are up worldwide. New products at Coke, like the mid-calorie C2, are floundering. And Coke's advertising hasn't had a hit since the Polar Bears were cubs. A plan that cuts consumer prices is expected soon to drive up volume, but won't necessarily help profits.

YAHOO! RAISES THE VOLUME

Hoping to bolster its position in the booming market for online music, **Yahoo!** on Sept. 14 acquired **Musicmatch** for \$160 million. Privately held Musicmatch boasts more than 200,000 subscribers to its ad-free radio service as well as millions of users of its desktop software for creating playlists and burning CDs. The purchase is intended to complement Yahoo's existing music service, dubbed Launch. It signals a serious

effort by Yahoo to tap a market that **JupiterResearch** expects to nearly triple in the U.S. this year, to \$270 million. Although Yahoo's Launch receives the most traffic of any online music site, according to **Nielsen//NetRatings**, the biggest moneymaker thus far appears to be **Apple Computer's** iTunes, where 70 million songs were downloaded in its first year.

ET CETERA...

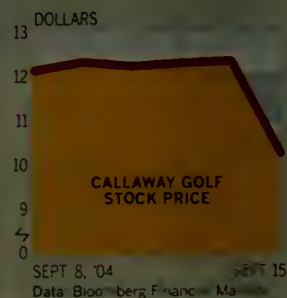
» Gary Muto will head **Gap's** new chain for boomer women (BW—Aug. 16).

» **Best Buy's** second-quarter net earnings rose 8%.

» A **Goldman Sachs** survey sees slower growth in 2004 and 2005 tech spending.

CLOSING BELL

Callaway Golf shares landed in a sand trap on Sept. 15, falling 16%, to \$10.33, after the company pulled its sales and earnings estimates. Callaway, which grew to nearly \$1 billion on its oversize drivers, has suffered due to competition from high-tech rivals and a costly move into golf balls.





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EDITED BY MIKE McNAMEE

Expensing Options: Reprieve for the Valley?

ON WEEKDAYS, JEFF SOLOF IS director of Sun Microsystems' Web site. On weekends, he's a deacon at an Eastern Orthodox church in Worcester, Mass. But the 44-year-old father of two has a dream: When he hits his 50s, he'll cash in his 40,000 Sun stock options and become a full-time minister. Stock options "are a long-term incentive" to stick with Sun, he says.

Solof will be singing options' praises on Capitol Hill on Sept. 21 as part of an 11th-hour lobbying blitz by the tech industry. Techies want Congress to blunt a proposed accounting rule that would require companies to subtract the expense of stock options from their earnings. With a bill that would sharply limit expensing stalled in the Senate, the tech set doesn't appear to have a prayer. So the way seems clear for the Financial Accounting Standards Board to approve its new regs in December.

But Silicon Valley and Route 128 aren't raising the white flag yet. Instead, they're opening a new front. On Sept. 14, lobbyists for Cisco, Genentech, and Qualcomm unveiled an alternative method for valuing options—and called on FASB to delay its rule so the standards-setters can study their formula. Their goal: Keep the options issue alive to fight again next year.

Alternative Formula

THAT PUSH FOR a delay is getting an inadvertent boost from the Securities & Exchange Commission—despite SEC Chairman William H. Donaldson's strong support for FASB's independence. In an Aug. 19 letter, he implored Senate Majority Leader Bill Frist (R-Tenn.) and 14 other influential senators not to meddle with the standard-setters. But the SEC has final say over when the FASB rule takes effect—and it has its own reasons for wanting to postpone it. SEC staffers worry that Corporate America already is struggling to meet other accounting deadlines. The most onerous is a Sarbanes-Oxley Act requirement that execs and auditors evaluate in-

ternal financial controls. "There is so much that already is being asked of preparers and auditors that now is not a good time for immediate implementation of a new expensing standard," says SEC Chief Accountant Donald T. Nicolaisen. While FASB wants the rule to take effect in January, Nicolaisen thinks expensing should be put off a year.

That suits the tech set—but won't keep them from pursuing the new valuation approach to buy some more time. Business has long groused that FASB's favored valuation methods, including the widely used Black-Scholes model, overstate the cost of options. The plan offered by Cisco, Genentech, and Qualcomm would tinker with as-

sumptions used in Black-Scholes on stocks' volatility and how long workers hang onto their options. The net effect: A 70% smaller hit to earnings, on average, than under Black-Scholes.

Initial reviews of the new formula are mixed. "The proposal has a lot of merit," says Fred Cook, founder of executive compensation consultants Frederic W.

Cook & Co. Others view it as a ploy to keep FASB at bay. This is "the least possible expense model" for valuing options and "unquestionably a delaying tactic," says Lynn E. Turner, former SEC chief accountant and now managing director of research at proxy adviser Glass Lewis & Co.

Turner warns that delay won't make the SEC's job any easier. In 1999, the agency bowed to business pressure and put off for a year new accounting rules for measuring revenue. The critics never ceased their attacks. The tech lobby isn't likely to cry uncle any faster. ■

—By Amy Borrus



TECH PROTEST
Workers in Palo Alto want options to stay the same

CAPITAL WRAPUP

VOTING EARLY, BUT NOT AS OFTEN

STATES ACROSS the country are liberalizing their early-voting rules and absentee-balloting procedures to encourage more Americans to vote. But a new study concludes that the attempts may be backfiring. The report by the Committee for the Study of the American Electorate indicates that nearly every state that encouraged early voting since 1988 has fared worse on turnout than similar states that did not make the changes.

Committee director Curtis Gans argues that early balloting forces parties to spread their get-out-the-vote resources over a longer time, weakening their impact. He says the changes also result in a more atomized and fragmented nation because fewer Americans share the communal experience of Election Day.

U.S. ELECTION FRAUD? THE WORLD WATCHES

NORMALLY, American election observers are dispatched to assure fair and free elections in Third World nations. But this year, that pattern is being reversed. Twenty experienced election monitors from Ghana, Zambia, the Philippines, and nearly a dozen other nations are coming to the U.S. to investigate "controversies that appear to be undermining public faith in the U.S. political process." They'll release a report in October and then return for the Nov. 2 balloting. The group includes monitors who have worked such hot spots as South Africa, Nicaragua, and Cambodia. Now they'll try to smoke out irregularities in Georgia, Ohio, Missouri, and, of course, Florida. The effort is sponsored by Global Exchange, a San Francisco human-rights group.

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RUSSIA

NEXT, THE ECONOMY?

Experts fear Putin may clamp down on free-market reforms

HOW FAR WILL PUTIN GO in turning back the clock? There's no doubt he's trying to centralize all political power inside the Kremlin. Hard on the heels of the Beslan massacre, he announced plans to abolish direct elections for governor in Russia's 89 regions, replacing them with direct presidential appointments, ostensibly to strengthen the Kremlin's hand in the fight against terror.

The names of the governors will have to be approved by regional legislatures, but this is sure to be a formality. There's no way an opposition could organize to block this move. National TV networks already are under government control, while Parliament is overwhelmingly dominated by pro-Putin parties. The Kremlin's concerted legal attack on the private oil company Yukos, whose boss, Mikhail B. Khodorkovsky, set himself up as a rival to Putin, also shows what happens when a prominent figure gets out of line. "Putin is all about salami tactics: cutting down one oligarch after another,

one television channel after another, at a slow and deliberate speed," says Anders Aslund, director of the Russian and Eurasian Program at the Carnegie Endowment for International Peace in Washington.

The big question now is whether Putin will extend this steady concentration of power to the economy—not a full-fledged return to Soviet-style economic management, but possibly a wide retreat from the free-market reforms Putin pursued during his first term, building on the legacy of his predecessor, Boris N. Yeltsin. If Putin does opt for more control, he risks killing the economic dynamism of recent years, which has been driven by the private sector.

CRONY CONTROL

THE SIGNS ARE not good. Here again the ultimate fate of Yukos, which the government has hit with a bill for back taxes of more than \$7 billion, will provide a signal of how far Putin wants to return to the old

ways. Most analysts are betting that Yukos' prime assets will be swallowed up by a new state oil-and-gas company, to be formed through the merger of government-controlled gas giant Gazprom and oil company Rosneft. The creation of this company was announced on Sept. 14, a day after Putin's dramatic move against the governors.

Putin's close associates are also strengthening their personal involvement in the management of key assets. Igor Sechin, a presidential aide, was recently made chairman of Rosneft. Gazprom Chairman Alexei B. Miller is an old Putin ally.

Déjà Vu: Again, Reaction Follows Reform

In 19th century **Russia**, the work of reform-minded czars was reversed by reactionary successors. Now, after a decade of change under Boris Yeltsin, **Put n** is centralizing political and economic power.

1991 to 1993

Soviet Union collapses. Yeltsin government's shock therapy program eliminates price controls and begins privatization of housing, stores, and small and midsize businesses.

1994 to 1996

Government sells off the country's crown jewels—the huge oil and metals companies—in controversial



privatizations to politically connected businesspeople. Many of these new owners, dubbed oligarchs, become billionaires who wield great influence over the Kremlin's economic policies. Yeltsin allows regions to hold direct elections for governors. Hundreds are murdered in turf battles for privatized assets.



Following the attack on Yukos, private business is cowed

Dann, doesn't see Putin's play for oil-sector control as putting a damper on foreign interest. "Controlling energy doesn't mean controlling everything else," he says.

But the worrying signs don't stop there. Since Putin's reelection in March, hardly anything has been done to push promised liberal economic reforms, such as measures to help small businesses by cutting back on red tape. Such moves are badly needed to diversify and

strengthen the Russian economy. "The reforms haven't happened, and there's no evidence they're about to happen," says Chris Weafer, head of research at Russia's Alfa Bank.

To promote liberalizing reforms, Putin would need the support of private business lobbies to push back against the bureaucrats. But following the attack on Yukos, business is cowed and its political influence weakened, argues Carnegie's Aslund. He says Putin is becoming ever more dependent on the security services and their allies at the large state companies and banks.

In recent months these groups have

been extending their influence not just in the oil industry, but in other key sectors. For example, the reform of Russia's pension system, which would have benefited private financial groups, has effectively been taken over by state-owned banks. "We have been shut out completely," complains Bernie Sucher, the chairman of private investment company Alfa Capital in Moscow. Other key privatizations, in sectors such as electricity and banking, have also been put on hold.

INEPT BUREAUCRACY

THE OTHER CONCERN is that Putin's obsessive focus on political control and mastery of the state's biggest companies is diverting him from the badly needed reform of the government apparatus itself. After Beslan, the failure of Russia's bureaucrats—among them the all-powerful intelligence service, the FSB—is obvious. "The federal bureaucracy has proved itself totally incompetent," says Stanislav Belkovsky, director of the National Strategy Council think tank. Yet by centralizing political power, Putin risks undermining the very forces in society that could provide some sort of counterweight to the bureaucrats and press for change. Putin will probably choose more strongmen—ex-generals, spies, and cops, known collectively in Russia as *siloviki*, or men of power—to fill regional government slots. In practice they'll be accountable only to the President himself, who cannot possibly supervise everything.

Russia is not headed for an immediate economic calamity—not with oil-fueled growth that could easily hit 7% this year. But there's an obvious risk that if Russia's rudimentary democratic institutions are curtailed, and the security services extend their influence over national life, economic liberalization will also suffer. The warning signals were there well before Beslan. Now they are ringing loud and clear. ■

—By Jason Bush in Moscow, with John Rossant in Paris

1996 to 1998

Yeltsin gains ever more wealth and political clout as average Russians suffer from inflation and unemployment. Barter flourishes. Government spends billions of dollars' worth of subsidies to finance wages and social programs. The government bond market and ruble collapse in August, 1998, and government defaults on domestic debt.

1999 to 2001

Yeltsin resigns at the turn of the century, naming Prime Minister Putin as acting President. Putin is elected President in March, 2000. In July, he trims power of governors by persuading them to give up seats in upper house of Parliament. Putin takes control over national television networks.

2002 to 2004

Russian economy booms as oil prices rise. Putin cuts income taxes, which quickly curtails black economy and boosts government coffers. In October, 2003, government arrests oil baron Mikhail B. Khodorkovsky on charges of tax evasion and fraud. In December, 2003, United Russia, a party loyal to Putin, gets control of the lower house

of Parliament, the Duma, and in March, 2004, Putin wins reelection by a landslide. After terrorists kill more than 300 people in Beslan in September, Putin proposes a sweeping political overhaul that would allow the President to nominate governors and restricts the ability of regions to elect their own representatives to the Parliament.

Data: BusinessWeek

EDITED BY PATRICIA KRANZ

A Dogfight Within The House of Labour

FALL IS PARTY-CONFERENCE SEASON in Britain, when the politicians head for seaside resorts to air gripes and jockey for position. You might think the rivalry everyone's watching would be Tory vs. Labour, especially as it's widely expected that Prime Minister Tony Blair will call an election by next spring. But the more

closely watched contest is between Blair and his tough Chancellor of the Exchequer, Gordon Brown, for control of the party—and ultimately of 10 Downing St.

Just a few months ago, Brown—who makes little secret of his desire to succeed Blair—had reason to think he would soon get his way. Brown was getting credit for Britain's sustained boom, while Blair's Iraq policy had sparked public outrage and his ratings were in the cellar. Blair also faced two potentially bruising government inquiries about his conduct. Labour Party insiders figured Blair was seriously considering handing over his post to Brown.

Undermining

NOW THE SITUATION is reversed. Blair is still disliked by many voters, but he has survived the probes, the economy keeps growing, and the Tories under Michael Howard have not made serious headway. "It looks as certain as anything can be that Blair will lead the party into the general election," says Peter Kellner, Chairman of pollsters YouGov.

What about Brown? The buzz is that Blair may try to shift Brown from his powerful treasury post or curb his role in the party. Blair is trying to place backers in positions where they could compete with Brown for the future party leadership. In an early-September reshuffle, Blair brought Alan Milburn, a former Health Secretary and Brown foe, back into the Cabinet. In the next campaign, Milburn will oversee the drafting of the party manifesto—a challenge to Brown, who has long been Labour's top political strategist.

"Mr. Brown is not dead yet, but Mr. Blair has tried to stab him through the heart of his ambition," writes *Independent* columnist Bruce Anderson.

Control Freak?

BLAIR HAS DRAWN assistance in his fight from an unlikely source—a book by former economic adviser Derek Scott, now being serialized by *The Sunday Times*. The book, *Off Whitehall*, is ostensibly about Britain's euro policy, but the political classes are reading it for insights into Labour's internal rivalries. In Scott's vivid and often hilarious account, Brown emerges as a big spender and a secretive control freak.

Brown, writes Scott, balked at sharing his plans with Blair on crucial matters such as budgets. "Give us a hint, Gordon!" Blair prodded, when Brown said he hadn't made up his mind about the 1998 budget a month before it was due. To figure out what Brown was up to, says Scott, Blair's aides took to behaving like "investigative journalists," smuggling offi-

cials from Brown's Treasury into meetings at No. 10.

Scott is also sharply critical of Blair—the government tried unsuccessfully to make Scott delete chunks of the book—saying Blair erred in ceding vast swaths of policy to Brown. But overall, it's Brown who comes off worse. Pundits think the book will add to the impression that the high-strung Brown is too inflexible to be an effective Prime Minister. Brown still has a solid core of support in the party, and he may yet regain the initiative. But it's Blair who seems set to lead Labour—and Britain—for years to come. ■

—By Stanley Reed in London



BLAIR ON TOP?

For now, he seems to be outfoxing Brown

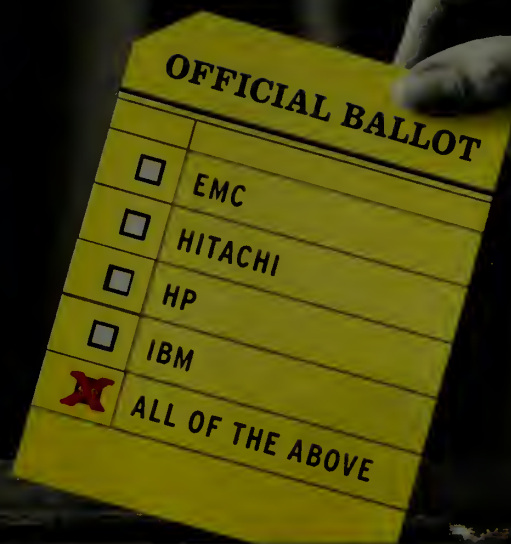
GLOBAL WRAPUP

A MEXICO-JAPAN TRADE DEAL

SIX YEARS AFTER former Mexican President Ernesto Zedillo first floated the idea, Mexico and Japan are set to sign an historic Free Trade Agreement. This is only Japan's second FTA; the first was with Singapore. The deal, which covers most industrial products along with certain agricultural goods and which takes effect in April, 2005, is expected to boost Japan's exports to Mexico by 30% and its imports from Mexico by 11%, according to a study carried out by the Japanese government. The two countries exchanged \$8.2 billion worth of goods last year. Japan ships mainly consumer electronics and heavy machinery to Mexico, while the Latin nation sends mostly agricultural products such as pork and processed goods such as tequila the other way.

ISRAEL'S PULLOUT PLAN

ISRAELI PRIME Minister Ariel Sharon is moving full speed ahead on his controversial plan to pull settlers out of the occupied territories. On Sept. 14 the Israeli Security Cabinet approved a framework package to compensate 12,000 settlers in the Gaza Strip and northern West Bank that could cost the government up to \$600 million. Initial payments will begin within two weeks. Sharon wants all settlers out by September, 2005, at the latest. In the meantime he faces numerous hurdles before the plan can be implemented, including calls from dissenters in his own Likud party for a national referendum on the disengagement. The plan must also be approved by the Knesset, which is scheduled to take it up in November.



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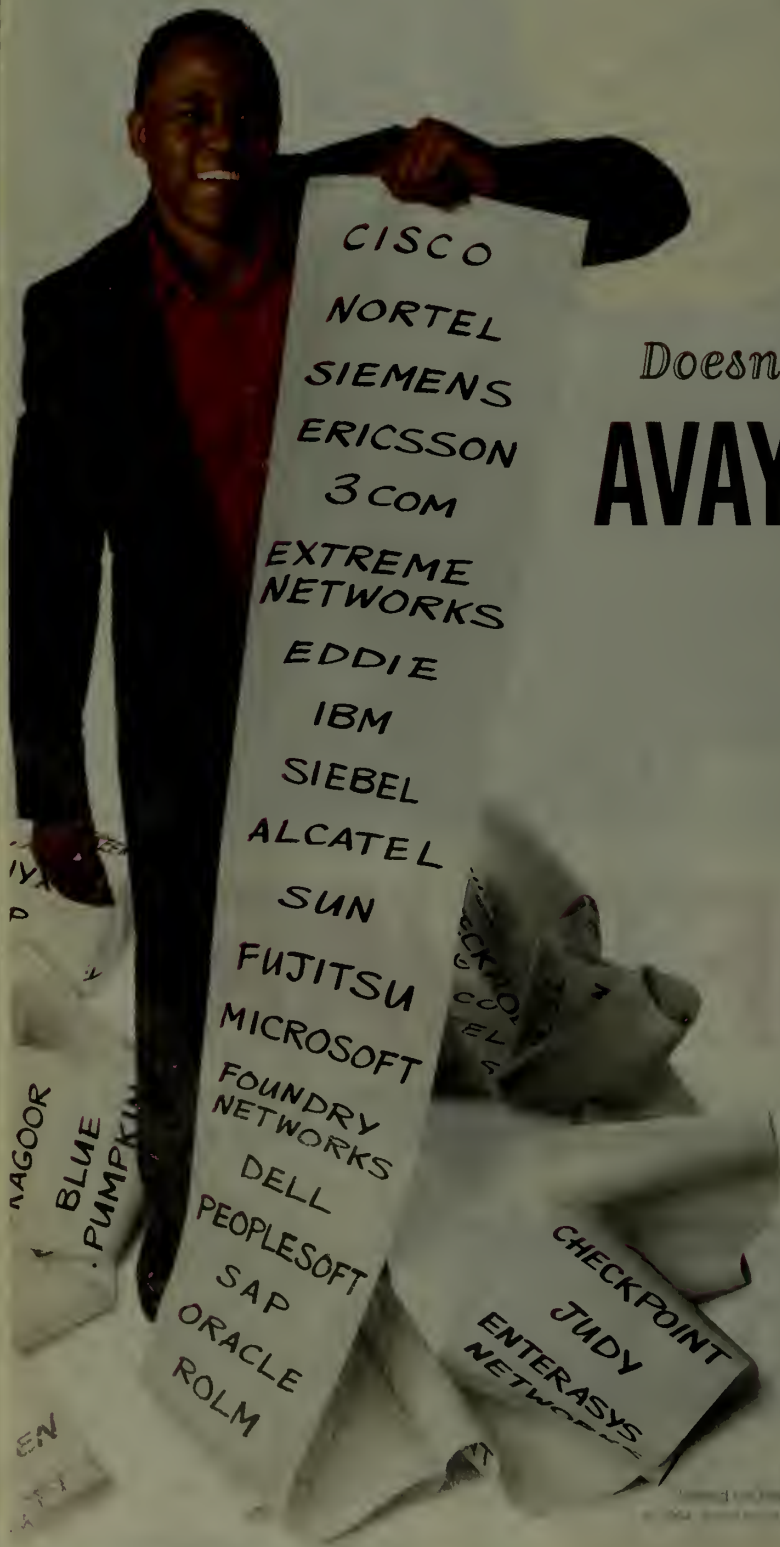
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IP TELEPHONY PRODUCTS & SERVICES

Internet-protocol, or IP, telephony — a collection of technologies, products, and services that, broadly described, encompasses the convergence of voice, video, and data on today's IP-based communications networks — is serving to radically transform communications as we know it. Indeed, the convergence occurring on these networks — including the Internet, broadband DSL, cable systems, and corporate LANs and WANs across the country — is creating a host of new opportunities for consumers and businesses looking for more choice, more value, and powerful new communications capabilities and applications.

THE WORLD OF IP TELEPHONY UNFOLDS

"Today, more and more Americans can get digital television from a telephone company, voice service from their cable company, wireless Internet from a whole other set of companies — and barely a day goes by when we don't read another announcement of a phone or cable company embracing Internet telephony," says Walter B. McCormick Jr., president

Photo: Lisa Quinones



> AT&T's Martine says that when legacy equipment becomes obsolete, IP telephony is inevitable.

and CEO of the U.S. Telecom Association (USTA), a trade association, representing more than 1,200 service providers and suppliers for the telecom industry, in Washington, DC.

The recent Olympic Games, in Athens, served as a coming-out party of sorts for AT&T. With advertisements for both its new "voice over IP" (VoIP) offering — AT&T CallVantage Service — and its network security capabilities, it was nearly impossible not to notice AT&T's presence during the televised broadcasts of the games. AT&T's commitment to the marketing

of VoIP is a testament to both the strategic importance and the maturity of IP telephony technology. The AT&T CallVantage Service is now available nationwide in 170 U.S. markets and is in trials overseas for use by remote workers of multinational corporations. All that's required to use the AT&T CallVantage Service is a telephone adapter provided by AT&T and a broadband Internet connection, which enables users to talk over high-speed Internet connections instead of traditional circuit-switched phone networks.

A ONE-STOP COMMUNICATIONS SHOP

In addition to offering the AT&T CallVantage Service, the company also provides an array of integrated VoIP and IP telephony business services. In particular, AT&T's IP Telephony LAN Services are designed to provide enterprise customers with the procurement, installation, configuration, day-to-day management, and life-cycle support of a customer's IP PBX network, providing a single point of contact for trouble resolution. AT&T IP Telephony LAN Services provide support for IP PBXs from companies such as Avaya, Cisco, and Nortel. AT&T also provides and supports the associated local- and wide-area networking (LAN and WAN) equipment, as well as a host of IP-based managed network services. In short, acting as a reseller and systems integrator, AT&T serves as a one-stop shop for IP telephony equipment and the IP transport services behind it.

According to Cathy Martine, AT&T's senior vice president, Internet telephony, in Bedminster, N.J., the timing couldn't be better for such new integrated service offerings: "Every year,

as more legacy phone equipment reaches the end of its life cycle, there's a greater incentive for companies to move in the direction of IP telephony. Why would you want to spend money on legacy replacement equipment? It's not a matter of if, but when, enterprises of all types and sizes will move to IP."

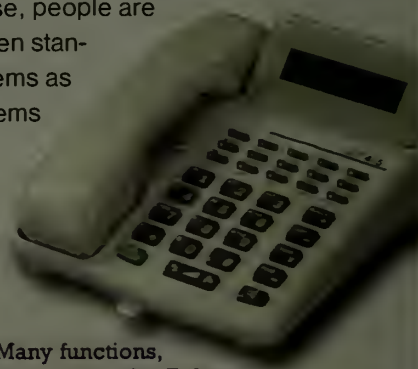
UK-based InterContinental Hotels Group PLC (IHG), one of the world's largest lodging companies, recently decided to make the move to IP telephony. IHG looked to AT&T to help it standardize services and costs across three properties, plus its data center in Atlanta, through the convergence of a single unified networking infrastructure. AT&T's VoIP Service now enables IHG to use the same bandwidth circuits to handle local and long-distance voice traffic, as well as hotel Internet services and data transmission.

"We are very much interested in the convergence of our network," says Gustaaf Schrijs, IHG's vice president of technology and services. "Our Holiday Inn prototype, which uses VoIP from the guest rooms, will be the first hotel in its class that has such capability." In addition to satisfying its business traveler requirements, the solution better positions IHG to achieve a lower cost structure. "We're extremely proud of our relationship with AT&T and the hard work accomplished to achieve this great result," adds Schrijs.

INTEGRATION AND OPEN STANDARDS GET THE GOLD

Zultys Technologies, based in Sunnyvale, Calif., designs and manufactures a range of IP-based business communications systems designed to serve from one to 10,000 users. One notable feature of Zultys's technology is that it's designed specifically to deliver completely integrated solutions. In Zultys's MX25 branch office and MX250 main office systems, for example, applications such as presence and instant messaging, fax, and voice mail are completely integrated with their IP PBX — all in a single box. Additionally, these products are based on industry open standards to ensure interoperability in any network and with a wide range of third-party products and applications.

According to Zultys's president, Iain Milnes: "Open standards are extremely important today. People expect the Ethernet connections on their laptops to connect into their networks. Likewise, people are getting savvy about open standards with phone systems as well. Since Zultys systems are based entirely on open standards like Linux and SIP, you can connect phones, video systems, voice recorders, data bases, and inter-active voice



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response systems from other manufacturers to our equipment and have the confidence that they will work."

One of the greatest features of enterprise IP telephony systems is the ability to seamlessly and inexpensively connect remotely to the corporate phone system — a boon to telecommuters and traveling professionals. Zultys's most capable IP phone, the ZIP 4x5, is a terrific example of such capability. With powerful, computer-like functionality, the Linux-based ZIP 4x5 incorporates a firewall and VPN (virtual private network) for security, Bluetooth technology for use with wireless headsets and voice-activated dialing, and an analog circuit for use over standard circuit-switched telephone networks. When you plug the phone behind a cable or DSL broadband connection, it instantly becomes your office extension.

For real-estate brokerage firm Coldwell Banker Elite, based in Fredericksburg, Va., the MX250 Enterprise Media Exchange and ZIP phones solved a nagging business problem: "In the real estate world, missing a call could mean missing a deal," says Kevin Breen, president of Coldwell Banker Elite. "The Zultys system keeps agents connected to their customers and to each other, regardless of whether they are in the office or across the city. And with the presence feature built into the MX250, agents can see whether other employees are available to talk. We have also been able to remove a third of our phone lines and slash our phone bill by 80 percent."



> Polycom's VSX 3000 conferencing system doubles as a computer monitor.

SEE ME, HEAR ME

Years ago, video conferencing systems generally cost \$35,000 to \$50,000 and were exclusively relegated to corporate boardrooms. Today, thanks to convergence, the pervasiveness of IP networking, and vast improvements in the price/performance equation, high-quality "video calling" is affordable for practically any business, whatever the size.

"IP has made advanced applications accessible to the customer, with high-quality audio and video and ease of use. Before IP, specific media types such as voice, video, and data were sent over disparate networks," states Stacy Saxon, marketing director for the video division of Polycom Inc., in Austin, Texas. "Today, as these can all run over a single IP network, enterprises now have a viable means to deploy these applications cost-effectively and in a highly integrated manner."

Polycom, a global leader in unified collaborative communications solutions, offers award-winning, best-in-class, IP-based desktop, office, and conference-room systems for businesses of all sizes. The company offers products that are part of a fully integrated solution for voice, video, data, and Web collaboration, as well as the middleware solutions that are needed to manage them and the network infrastructure solutions that are needed to expand and multiply them company-wide.

Polycom recently introduced a number of new products that have made video conferencing as simple as making a phone call. Polycom's new VSX 3000 personal video system integrates a camera and computer display, adds video conferencing capabilities, and connects to a PC

TRANSFORMING BUSINESS
IP TELEPHONY PRODUCTS & SERVICES >>



VoIP vs. VoIQ



ZULTYS

THE WORLD OF IP TELEPHONY UNFOLDS

where it doubles as the computer monitor. And with the integration of the company's revolutionary SoundStation VTX 1000 wideband conference phone and VSX 7400 group video conferencing system, customers can now initiate a video call from the familiar user interface of their conference phone.

"We are very pleased with the new capabilities of Polycom's solutions," says Dave Christensen, senior technology specialist with The Church of Jesus Christ of Latter-day Saints in Salt Lake City, Utah. "Polycom StereoSurround is an impressive feature that adds a unique spatial dimension to conferencing that can enhance the overall clarity and intelligibility of a call. And the new VSX and SoundStation VTX 1000 integration will help our users easily get calls

up and running, help to declutter the conference-room table, and enable the simple and seamless addition of audio participants to a video call. Remote management is also key, and the new Web Director is a critical application that includes extensive functionality for our video network administration."



> Avaya IP Agent, a soft-phone application for PCs, enables call-center agents to work anywhere.

IP IN THE CONTACT CENTER

IP-enabling a contact center serves to dramatically lift agent productivity and overall site efficiency to new heights, as well as help rationalize costs by enabling the consolidation of resources where they make the most sense. IP contact-center solutions, from such leading companies as Avaya Inc., in Basking Ridge, N.J., and Telephony@Work Inc., in La Jolla, Calif., add a host of new IP-based communications features and support and leverage a geographically dispersed workforce, including customer service, technical support, and sales staff.

According to Eli Borodow, CEO of Telephony@Work: "There are tremendous inefficiencies in maintaining separate systems and IT staff at each location. The IP-based approach eliminates these problems and enables agents to work from any location. This dramatically reduces operating costs and allows companies to gain economies of scale by sharing software licenses across geography. Traditional regional objections related to loss of local autonomy on shared infrastructure can now also be easily addressed with 'multi-tenant' technology, which provides remote locations with the ability to modify their own local business practices on demand."

Jim Smith, Avaya's vice president, applications product management, agrees: "IP is really changing the paradigm of what a contact center can deliver. IP telephony has enabled

the connectedness of the entire enterprise, entire supply chain, and entire set of business partners, so that there are unique things available to improve the level of service that a company is giving."

Telephony@Work's highly scalable and flexible "Customer Interaction Management" system — called CallCenter@nywhere — is designed for both enterprises and service providers. The system is "Integrated-by-Design" to eliminate the need for the costly programming, integration, and regression testing that are ordinarily required with traditional legacy equipment. CallCenter@nywhere incorporates all the phone, fax, and Internet communications technologies required by today's contact centers.

One Telephony@Work customer is the Canadian market share leader in office products, Grand & Toy, a Boise Cascade Corp. company, based in Ontario, Canada. It recently migrated to Telephony@Work's IP-based technology and unified its geographically dispersed sites with centralized infrastructure. This migration provided diverse benefits, including dramatically reduced technology operating costs, the implementation of Internet-based communication channels to enhance customer satisfaction and reduce transaction times and costs, and the empowerment of local managers with real-time adaptability to changing needs from browser menus. According to John Melodysta, vice president, IT, for Grand & Toy: "Telephony@Work empowered us to unify our organization, increase per-seat revenue, and reduce our operating costs — quickly, easily, and without business disruption."

Avaya, a leading global provider of business communications software, systems, and services for businesses, has also worked tirelessly to evolve its technology for the age of IP telephony. Today, the company offers an array of IP-PBX systems, as well as a wealth of IP-based contact center applications.

The Avaya Customer Interaction Suite, a suite of contact center software solutions that is part of the Avaya family of IP-based MultiVantage Communications Applications, features new and advanced capabilities that deliver personalized customer service across any communications channel, helps contact centers manage compliance with state and national "Do Not Call" registries, and improves the scalability of self-service.

Avaya IP Agent is another application that is specifically designed to accommodate call center agents working

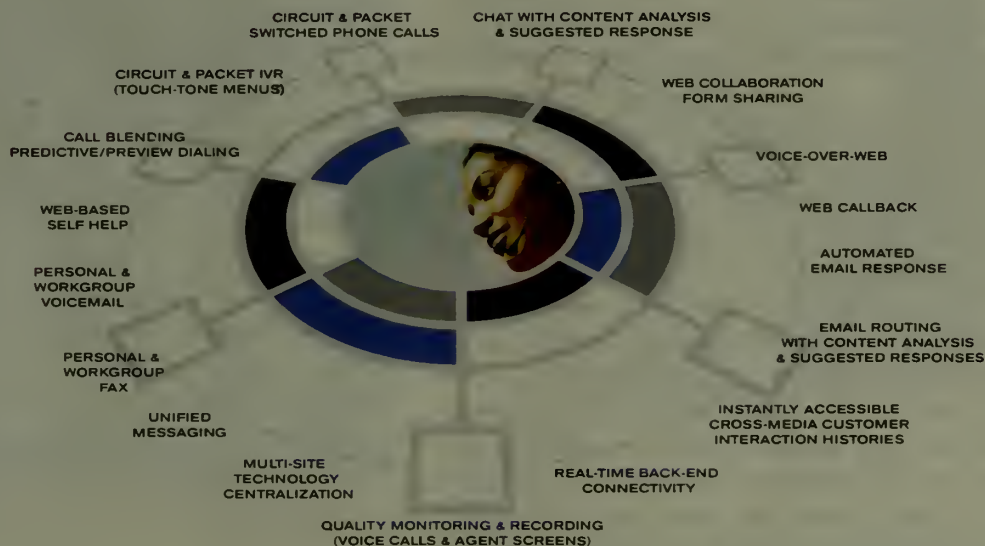


> Telephony@Work's Borodow says IP technology helps to integrate human resources across the company

How Do You Increase Contact Center Revenues AND Slash Operating Costs?



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Most vendors require lots of time and money to program, integrate, implement and maintain multimedia contact centers or share technology across geography. They also can't implement changes without costs, risks and delays. And by the time "upgrades" are delivered, your needs may have changed. Telephony@Work technology leverages traditional needs-analysis questions yet allows your managers to define (or redefine) their answers via browser menus - in real-time and at no cost. This enables them to provision or modify any business process on-the-fly in order to increase efficiency on any communications channel - phone, fax or Internet - for any group, anywhere in the world. As you might expect, increased revenues are the natural result of being able to "fix" broken or strained business processes on demand.

TELEPHONY
@work

CALL CENTER & E-CONTACT TECHNOLOGY MADE EASY

THE WORLD OF IP TELEPHONY UNFOLDS

remotely or in an office location. Avaya IP Agent is a Windows-based call-center softphone application that runs on a PC, and enables agents to work anywhere, as long as they can connect to the corporate network. Agents have access to the full range of Avaya agent capabilities using a graphical user interface that works via standard drag-and-drop conventions.

Tower Travel Management, one of the largest independent, full-service travel agencies in the U.S., with main contact centers in Oakbrook and Chicago, Ill., and remote agents in Texas and Tennessee, looked to Avaya for help in improving customer service while at the same time lowering the company's costs. Tower Travel deployed the Avaya IP Office solution, was quickly able to unify the many locations from which agents worked, and provided a single call queue to handle customers' calls more effectively.

A big bonus was in the significant cost savings produced by the system. According to Michael Foster, Tower's IT project manager: "The system eliminated the need for expensive T1 lines for remote workers. Instead, DSL or cable modems are used to connect agents to the system. Our Tennessee agent alone had a long-haul 56-K line connecting her to our network, costing us \$1,500 per month. Now she has a \$90-per-month cable modem with a static IP address. The savings our company has realized by eliminating T1 lines alone almost pays for the system."

THE FUTURE IS HERE TODAY

Level 3 Communications Inc., a carrier to other service providers and resellers, has a global network optimized end to end for IP technology and was built from the ground up with convergence in mind — that is, to carry voice, data, and video services. Recently, Level 3 introduced new hosted, wholesale VoIP business services to give its channel partners entrée to this exploding marketplace.

Level 3's new (3)Tone Business service is designed to deliver low-cost, highly reliable local and long distance VoIP services to small and midsize businesses in a variety of industries, including health care. With (3)Tone Business service, customers can manage their own telecommunications needs in real time through any Internet access, browser, or wireless device, while saving significant capital and operating costs over more traditional alternatives such as PBX, IP-PBX, key system, or Centrex.

Level 3 and IP Business Solutions, a New York-based VoIP supplier and Level 3 partner, is supplying (3)Tone Business to 1,500 members of the Queens-Long Island Medical Group PC (QLIMG), a physician-owned medical group with 21 offices throughout Queens, Nassau, and Suffolk counties in New York. The sale represents one of the industry's largest business VoIP installations to date. By enabling QLIMG to consolidate multiple networks for voice and data into one converged network, the new VoIP services will enable the group to lower its communications costs by about 40 percent.

It's clear that IP telephony can deliver immediate cost savings and offers an array of new features that promise to boost corporate productivity and efficiency. But simply installing the technology or turning on the service is often not enough to guarantee the promised results. Preparation and education are key as well.

According to Martine at AT&T, there are two areas that are most critical for a successful deployment: "One is ensuring that the infrastructure can support it appropriately from a WAN/LAN perspective. The other is creating an environment through training that makes the end user successful. Without the first, things just won't work. And without the second, people will be inflexible to the business process change that is essential for enterprises to enjoy the maximum cost savings and benefits of the technology."

ABOUT THE AUTHOR

Marc Robins is an internationally known authority in the field of IP telephony and emerging new communications technologies, with more than 23 years experience in the communications industry as a reporter and analyst, conference producer and publisher, and marketing executive and consultant. From 1998 to 2003, Marc served as vice president of publications and trade shows and group editorial director at TMC, publisher of the trade magazine *Internet Telephony* and producer of the *Internet Telephony Conference & EXPO* trade shows, for which he also served as chief architect and conference co-chairman. Most recently, Marc founded a technology marketing communications company offering an array of marketing and other services. For more information about Robins Consulting Group services, contact Marc at 718-548-7245 or e-mail robinsconsult@optonline.net.

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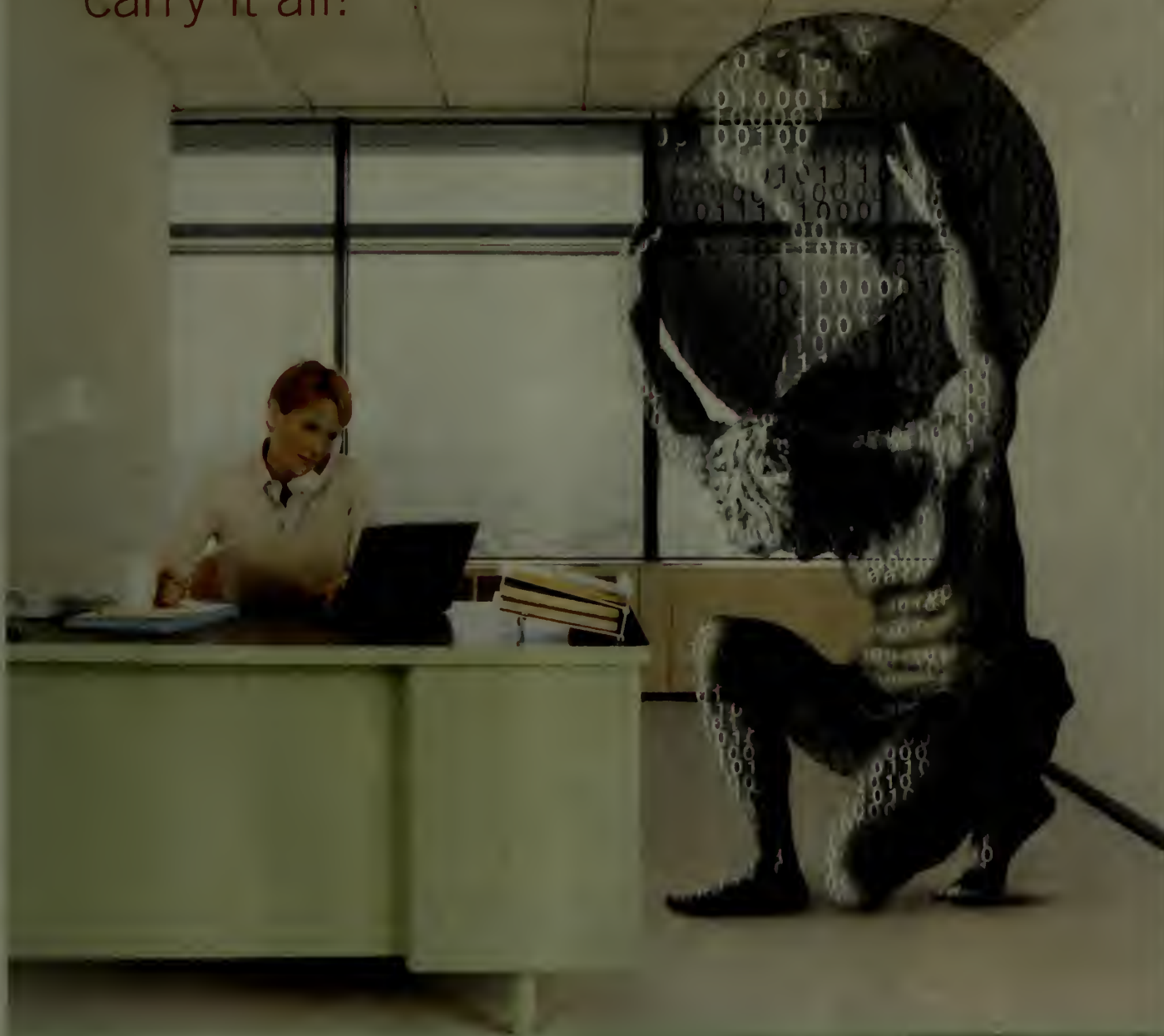
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KB Home: Rebuilding Trust

The homebuilder is putting the emphasis on quality—and raising its growth targets

IN MID-JULY, DIANA FRANCIS, A disabled retiree in Jacksonville, Fla., had a small fire in her home that caused firemen to knock down her front door. Panicked because she was about to leave on vacation, Francis called Bill Robinson, the local customer service manager for KB Home, the company that sold her the house two years earlier. Robinson spent five hours fixing the door, lock, and alarm system at no charge to Francis. "They've done above and beyond," she says.

That's good news for the \$5.8 billion Los Angeles-based homebuilder, once known as Kaufman & Broad Home

Corp. Satisfied customers haven't always been the norm at KB, which still operates under a 1979 Federal Trade Commission consent decree stemming from inadequate home warranties and poor handling of complaints about shoddy construction.

In the past two years, however, the company has moved forcefully to build a new image, as longtime Chairman and Chief Executive Bruce E. Karatz has instituted a bevy of changes. KB, the fifth-largest U.S. homebuilder, has worked with the National Association of Home

Builders to produce training programs for contractors and builders that Karatz says are boosting quality. Karatz has instituted a "Say Yes" program to handle customer complaints faster. And he has taken steps to bring independent voices to the KB board.

Karatz thinks that these changes, along with KB's move into markets beyond the \$200,000 starter homes that are its bread and butter, will ensure prosperity. As housing markets boomed, KB's sales climbed at a 17% average annual rate over the past 10 years, while profits grew at a 25% pace. Last year, KB earned \$371 million. Its performance was good enough to make it No. 49 on the BusinessWeek 50 list of top-performing companies.

And KB is now the largest builder in fast-growing cities such as Las Vegas and San Antonio, where higher interest rates have so far failed to dampen sales. Karatz figures that as KB expands its offerings for affluent empty-nesters, trade-up

buyers, and two-income childless couples—buyers it deems less sensitive to rising interest rates—it can hit \$10 billion in sales by 2007.

But rehabbing the KB name is crucial to meeting those targets. As the construction industry consolidates, with the top 10 homebuilders doubling their share since 1997, consumers are more aware of the reputations of the companies that are left standing. "In every other consumer product, brand does make a difference," Karatz says. "Why not housing?"

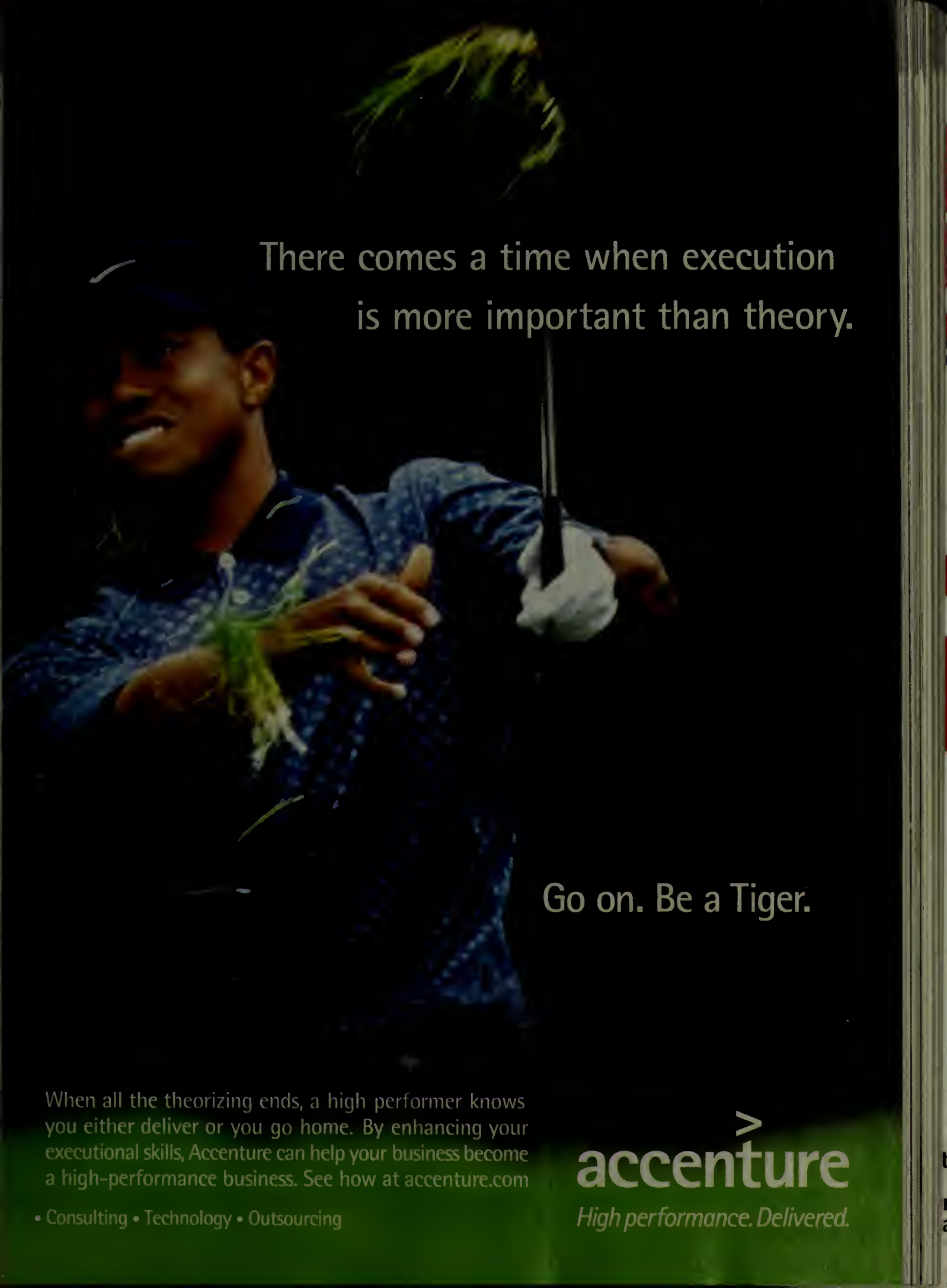
CONTRACTORS WHO CARE?

TO ADDRESS QUALITY concerns, Karatz is requiring that all of KB's contractors pass a certification course it helped develop with the NAHB. It includes follow-up site inspections by independent auditors and yearly recertification. Karatz is also asking his local managers to settle customer complaints within 72 hours. (The consent decree mandates resolution in 30 days.) A new KB standard states that "All reasonably legitimate homeowner concerns raised during the first year of ownership should be repaired or resolved to the homeowner's satisfaction. Period."

The payoff: KB says its warranty claims are down 90% from where they were two years ago, while lawsuits and legal expenses have fallen 20%—even though the company is building 25% more homes. Customer referrals, meanwhile, are way up. The annual J.D. Power



A DIFFERENT TUNE
Longtime CEO Karatz instituted a range of buyer-focused changes

A photograph of Tiger Woods in a celebratory pose, wearing a blue patterned polo shirt and a dark cap, holding a golf club. The background is dark and out of focus.

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& Associates Inc. customer satisfaction survey also shows rising approval of the company by home buyers. "KB is among the most improved in terms of customer satisfaction," asserts Paula Sonkin, senior director of the real estate industries practice at J.D. Power.

Karatz's remodeling has extended to his board as well. Former Housing & Urban Development Secretary Henry G. Cisneros, who has a homebuilding joint venture with KB, has left the board after talking with Karatz. Today 10 of KB's 11 directors are independent, including newcomers like Leslie Moonves, Viacom Inc.'s co-president.

KB still has its detractors. Brian Zaltsberg, an unhappy former KB homeowner, runs kbhomesucks.com, a Web site devoted to KB griping. "I still get complaints every day, from all over the country," he says. And Nancy Seats, national president of the Homeowners Against Deficient Dwellings Inc., a consumer advocacy group based in Eureka, Mo., says of KB: "They talk a good talk, but they don't walk the walk."

It may turn out that building a better reputation takes longer than building a new subdivision. But at least KB seems to recognize that it's bad business to have regulators knocking at the door. ■

—By Christopher Palmeri in Los Angeles

Cleaning House

Under attack from housing activists and dissatisfied buyers, KB Home is trying to improve its business practices

"JUST SAY YES" This KB initiative encourages managers to settle customer complaints quickly, even if the company is not at fault. One local complaint rep even posted his phone numbers on a Web site dedicated to unhappy customers.

BETTER BUILDERS To help improve quality, KB works only with contractors who pass a National Association of Home Builders-sponsored training program. They must be recertified every year.

NEW VOICES CEO Karatz has sought more independent board members. Former HUD chief Henry Cisneros, who has a joint-venture with the company, has left the board. Ten of 11 KB directors are now independent.

EX-AG SECRETARY

He'll be plowing into filmmakers' digital foes



He's Not in Kansas Anymore

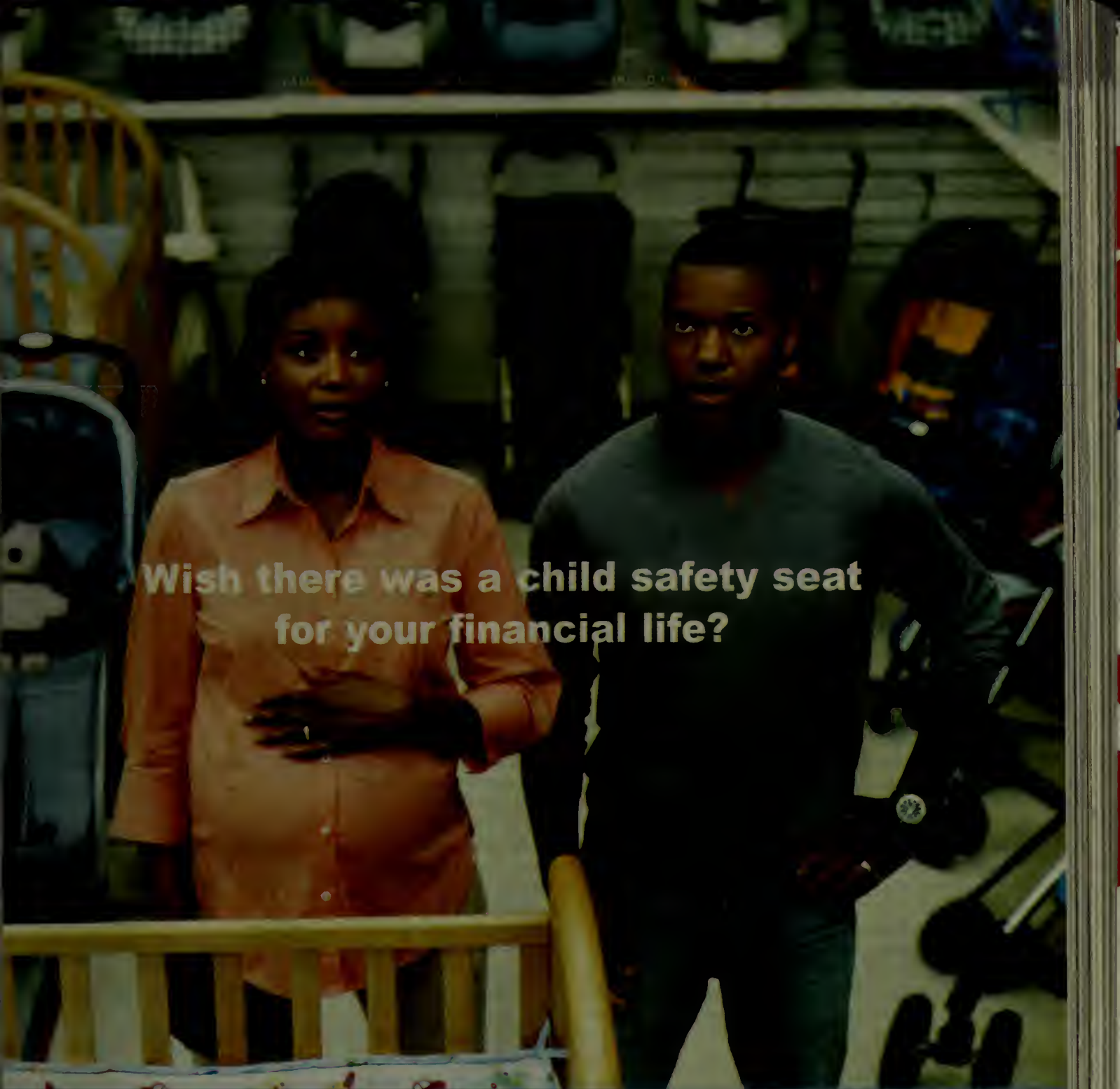
Genial prairie pol Dan Glickman is now Hollywood's leading man in Washington

IF CENTRAL CASTING WERE picking a lobbyist for the film industry to replace the flamboyant Jack Valenti as head of the Motion Picture Association of America, it probably wouldn't have gone to Kansas. But top moguls at Hollywood's seven big film studios wanted a proven politician known for his ability to bring people together. That's how Dan Glickman—a former Agriculture Secretary and House Democrat from Kansas known more for crafting soybean policy than schmoozing at Spago—found himself trading quips recently with California Governor Arnold Schwarzenegger at the Republican National Convention. During a bash on Sept. 2 for Valenti at the Rainbow Room, the Gover-

nator teased Glickman that he had large shoes to fill—but that with big feet like his, there should be no problem. It was only Glickman's second day on the job.

Coming on the heels of Valenti's 38-year run, Glickman's leading role will be quite a challenge. A diplomat by nature, he is walking into a nasty crossfire between the movie and tech industries over how much copyright protection will make movies safe from digital piracy. Everyone's digging in. "You have to wake up in the morning and fight a war. There's no compromise," says Alex Yemenidjian, CEO of Metro-Goldwyn-Mayer Inc. Counters Markham Erickson, general counsel for the Net Coalition representing the Internet service providers: "Hollywood's knee-jerk reaction should

Walking into studio-tech crossfire over copyrights



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not be to fight technology but to embrace it."

So what's the former farm-state lawmaker doing in this Hollywood shoot-out? While the down-to-earth Glickman cuts a figure quite different from the suave Valenti, the Wichita native garnered respect for brokering tough issues during nine terms in Congress and as Ag Secretary during the Clinton Administration. Now he'll need to find a middle ground not only with the tech industry but also among the studios. Of the seven, Warner Bros. Entertainment, Twentieth Century Fox, and Sony Pictures Entertainment are owned by cable, satellite, or electronics outfits on the other side of the digital copyright debate. Glickman is up to the heavy lifting, insist his closest fans. "He's more about the steak than the sizzle," says Glickman's son, Jonathan, 35, president of Spyglass Entertainment Group, which made the *Rush Hour* movies.

MICHAEL AND FREDO

STILL, THE ELDER GLICKMAN, 59, has a little show-biz streak himself. A film buff, he and his wife, Rhoda, watch as many as 100 movies a year. He and his son have seen *The Godfather* so often that they often reenact scenes—with Dan playing Michael Corleone to Jonathan's Fredo. "The movies are a powerful influence on people's lives, as well as on the portrayal of America," he says. "The only thing that keeps that foundation secure is the protection of creative rights."

Studio chiefs also appreciate that Glickman's centrist politics can help pave the way in Washington. Countering charges from GOP activist Grover G. Norquist that picking a Democrat is an insult to the Bush Administration and the Republican-controlled Congress, News

Glickman's centrist politics appeal to Hollywood

Corp. President Peter Chernin says: "We would never hire someone for just one Administration. Who knows who will win over the next 20 years?" Glickman is known as a bipartisan player and has brokered a bagful of contentious food issues. That includes toning down the Clinton Adminis-

tration's gung ho attempts to export genetically modified foods to meet objections from other nations. Indeed, studio chiefs think Glickman's global relationships will help win stronger copyright protections overseas. The debates Glickman has navigated certainly prepare him for the acrimony of the digital copyright wars. The organization under Valenti, who once likened VCRs to the Boston Strangler, had taken a hard line against the illegal transmission of digital content. Although U.S. broadband speeds are still too slow for convenient movie downloading, the studios want to avoid the devastation the Internet has wreaked on the music industry. So they're pushing legislation to make owners of peer-to-peer networks liable if their systems are used for illegal uploads. On the other side, software and electronics makers insist they support strong copyright protection but say Hollywood's safeguards will choke off innovation. The pending bill, they contend, would gut a landmark 1984 Supreme Court decision that allowed copying devices to be used in ways that don't infringe on copyrights.

The inevitable impasses to come will now be Glickman's to break. "Personal relationships are of the utmost importance," says Valenti. Working with Hollywood, Glickman will need all the pals a friendly Kansas pol can muster. ■

—By Catherine Yang in Washington, with Ronald Grover in Los Angeles

Filling Valenti's Guccis

In his newest starring role as head of the Motion Picture Association of America, Glickman will have challenges on all sides, including:

BUILDING BRIDGES TO THE GOP The former Democratic lawmaker and member of the Clinton Cabinet will have to convince the ruling party in Congress that he's a friend to those on both sides of the aisle.

DEFENDING COPYRIGHTS Glickman will be wrangling with equally aggressive technology and consumer electronics industries over a variety of pending digital copyright bills.

FENDING OFF FOREIGN PIRATES His prior gig as Agriculture Secretary will come in handy as he taps overseas connections to help go after Internet piracy abroad as well as the prevalence of bootlegged DVDs.



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¹ Based on fees charged for service/maintenance of non-retirement brokerage accounts. **Fidelity:** Fee waiver may not apply if account balance falls below \$30,000 in assets; **Schwab:** Fee is charged quarterly (\$30.00) on a per-account basis and is based on household balances depending on services received in the Schwab Independent Investing Foundational Program (Schwab Account and Schwab One® Account). Fee may be fully or partially waived if certain conditions are met. **Vanguard:** Fee charged annually on brokerage accounts open for 1 year or more. Firm offerings differ and may change over time; carefully consider the details of each.

² The following qualifications apply: **Fidelity:** Households that place at least 120+ stock, bond, or options trades in a rolling 12-month period plus \$30K in assets across eligible Fidelity Brokerage Accounts or who have \$1 million in assets are eligible for \$8 trades. See brokerage commission and fee schedule for complete details; certain restrictions apply. **Schwab:** Independent, self-directed active traders may receive \$9.95 flat pricing by enrolling in Schwab Trader CT. **Vanguard:** Clients with less than \$250,000 in Vanguard assets pay \$25 or \$0.025 per share, whichever is greater. Competitive assessment as of 8/4/04.

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TECH'S FUTURE

With affluent markets maturing, tech's next 1 billion customers will be Chinese, Indian, Brazilian, Thai... In reaching them, the industry will be deeply transformed

BY STEVE HAMM

IN RECENT MONTHS, THE ANDHRA PRADESH PROVINCE IN SOUTHERN INDIA HAS BEEN THE site of a rash of farmer suicides. Drought and low-quality seeds have left poor farmers with failed crops and no way to pay their debts. Many have swallowed lethal doses of pesticides as their only escape. Government officials estimate the toll since May at more than 60.

Against this bleak backdrop, a ray of hope: Neelamma, a 26-year-old woman, has found opportunity as a new type of entrepreneur. She's one of a dozen itinerant photographers who walk the streets of their farming communities carrying small backpacks stuffed with a digital camera, printer, and solar battery charger. As part of an experiment organized by Hewlett-Packard Co., Neelamma and the others are able to double their family incomes by charging the equivalent of 70¢ apiece for photos of newborns, weddings, and other proud moments of village life.

To make this happen, HP had to throw out its notions of how the tech business works. Anand Tawker, the company's director of emerging-market solutions in India, and his colleagues wrestled with fundamental questions: Does computing technology have a place in villages where electricity is fitful? Could it improve people's lives? How could villagers living in poverty pay for the latest digital wonders? And they came up with answers. In place of standard electricity, HP designers created the portable solar charger. Instead of selling the gear outright, HP rents the equipment to the photographers for \$9 a month. "We asked people what they needed. One thing kept coming up: 'We want more money in our pockets,'" says Tawker. "So we do experiments. We launch and learn."

Why go to all that trouble? The answer is fast becoming obvious. During the first 50 years of the info-tech era, about 1 billion people have come to use computers, the vast majority of them in North America, Western Europe, and Japan. But those markets are maturing. Computer industry sales in the U.S. are expected to increase just 6% per year from now to 2008, according to market researcher IDC. To thrive, the industry must reach out to the next 1 billion customers. And many of those people will come not from the same old places but from

A woman with dark hair, wearing a red top and a red flower garland, holds a silver digital camera. The background is a textured, light-colored wall.

INDIA

In Andhra Pradesh, HP is testing a novel strategy: Renting gear to villagers

POINT, SHOOT, PRINT

Neelamma pays HP \$9 a month for a photo kit

INFORMATION TECHNOLOGY

far-flung frontiers like Shanghai, Cape Town, and Andhra Pradesh. "The robust growth opportunities are clearly shifting to the developing world," says Paul A. Laudicina, managing director at management consultant A.T. Kearney Inc.

Tech companies are scrambling to cash in on what they hope will be the next great growth wave. Led by China, India, Russia, and Brazil, emerging markets are expected to see tech sales surge 11% per year over the next half decade, to \$230 billion, according to IDC. What makes these markets so appealing is not just the poor, but also the growing ranks of the middle-class consumers. Already, there are 60 million in China and 200 million in India, and their numbers are growing fast. These newly wealthy consumers are showing a taste for fashionable brands and for products every bit as capable as those available to Americans, Japanese, and Germans.

That tantalizing opportunity is drawing all of tech's big players. Microsoft is hawking software in Malaysia, Intel is pushing its chips in India, Cisco Systems is in Sri Lanka, and on and on. IBM says emerging markets are now a top priority. "We'll be even more aggressive," says IBM Chief Executive Samuel J. Palmisano. In Brazil, where IBM's revenues just zoomed past \$1 billion, Big Blue plans on hiring 2,000 people and spending an additional \$100 million on market development.

A Rival in Every Port

FOR TECH'S GIANTS, this is the equivalent of America's basketball stars playing Argentina in the Olympics under international rules. The leaders are just as vulnerable to upset because they're facing companies that grew up in these markets and know them intimately. Just look to China, where homegrown Lenovo Group Ltd. has fought off Dell and other invaders to remain the top PC player. The Western powers may be accustomed to dominating in the developed world, but as the competition shifts to new terrain, their lock on the future is far from secure. They face stiff challenges from service companies in India, online gaming pioneers in Korea, security outfits in Eastern Europe, and network gearmakers in China. Even mighty Microsoft is vulnerable. Open-source software, with growing support in developing countries, could stunt its growth.

The closest historical precedent for what's happening now is the PC revolution of the late 1970s and early 1980s. Before the PC, computers were the province of technical druids in giant corporations and government offices. Then with Apple Computer Inc.'s Macintosh and IBM's PC, the tech industry underwent a huge market-expanding shift. Computers began to show



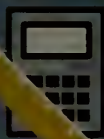
up on the desktops of everyone from schoolchildren to small-business owners. The result was seismic change. Microsoft, Intel, and Dell became the new champions, while dinosaurs like Digital Equipment lumbered off to the tar pits. Now, with rapid diffusion of technology into emerging economies, the industry is again reaching a gigantic new audience. And a new generation of companies will try to kick their elders in the teeth.

Expect a power shift from West to East. That's because the PC-centric era, dominated by U.S. companies, is fast giving way to the wireless age. The trend is most apparent in Asia, where cell phones with Net access are the computing gizmo of choice. While 30 million PCs are expected to be sold there this year, that pales in comparison to the 200 million cell phones capable of handling e-mail and Web surfing that researcher Yankee Group projects. That gives an advantage to Korea's Samsung Group and LG, which make cell phones as well as PCs. In the past four years they've come from nowhere to become the No. 3 and No. 6

HOW THE TECH INDUSTRY IS CHANGING

The rapid growth of sales in developing countries is having a profound impact on the tech industry. Companies must reimagine how they design products and do business.

DESIGN



Products have to be simpler and more durable. TVS Electronics, an Indian printer maker, is producing devices for India's 1.2 million small

shops. They're an all-in-one computer, cash register, and inventory-management system. They can be operated with icons, because many clerks are illiterate. And they tolerate dust and heat.

INNOVATION



Companies have to innovate for the peculiarities of emerging markets. Electricity often is unavailable or unreliable. That

prompted Hewlett-Packard to design a small solar panel to charge digital prints for itinerant photographers in India. In South Africa, HP is working with a solar fabric that's cheaper and less fragile.

BRAZIL

IBM's revenues here recently sailed past \$1 billion. No wonder it has plans to hire 2,000 people and spend big bucks here

CAREER CHANGE

De Santana got an IT job after one computer course

mobile-phone makers in the world. "In the 20th century the torch came across the Atlantic from Europe to America. Now the torch is crossing the Pacific," says Geoffrey A. Moore, managing director at tech consultancy TCG Advisors LLC.

The challenges of succeeding in emerging markets are forcing the Western powers to come up with bold new strategies. They're under pressure to innovate like crazy, pioneer new ways of doing business, and outmaneuver their feisty new competitors. "The pattern in the past was to sell the same stuff to the same kind of customers. But that won't work, and it has to change," says C.K. Prahalad, business professor at the University of Michigan Business School and author of *The Fortune at the Bottom of the Pyramid*, a book about commerce in the developing world. "What's required is a fundamental rethinking of how to design products and make money."

The result is an outpouring of innovation, from both the old guard and the up-and-comers, that could rival that of the PC era.

The Indian photographer's setup is just the start. New innovations designed for the developing world range from the Simpler, a durable handheld being sold in India, to e-Town, a package of all of the products and services rural Chinese towns need to provide Net access for their residents. And who would have thought up a cell phone designed for the world's 1.4 billion Muslims? Nobody—until now. Tiny Dubai-based Ilkone Mobile Telecommunication has just started selling a phone that not only comes loaded with the Koran but also alerts people at prayer times and with the help of a compass, points them toward Mecca.

Developing countries require new business strategies as well as new products. Most families in rural China or India can't afford a PC. In many instances, a handful of computers have to be shared by a whole village to be economically feasible. A new class of businesses—tech kiosk operators—is emerging to provide computing as a service. With cash often in short supply, pay-as-you-go programs are not only boosting cell-phone usage but are catching on with computers and Web access as well.

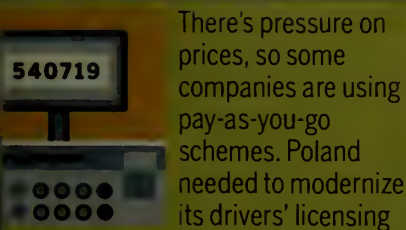
When these technologies cycle back into the mature market, it could change everything from pricing to product design. To succeed in the developing world, devices and software have to be better in many ways: cheaper, easier to use, extra-durable, more compact—and still packed with powerful features. The resulting improvements will ultimately benefit everybody from New Delhi to New York. One possibility: HP is testing a solar fabric with itinerant photographers in South Africa that costs 80% less than the traditional solar panels that they use in India and won't crack. If this works out, people around the world could recharge their portable electronics by dropping them in carrying cases made of the material.

Creating Consumers

FOR TECH'S POWERHOUSES, this shift to emerging markets cuts both ways. They have a chance to round up many new customers, but only if they're smarter than their new competitors. They'll have to invest substantial sums of money up front. Yet, for many products, prices will of necessity be very low. While the first billion customers produced an industry with more than \$1 trillion in annual revenues, sales for the second billion won't be anything close to that. And ultimately, lower prices in the emerging markets will put pressure on prices everywhere. You could end up with an industry that, while it delivers a lot of value to a lot of people, it won't be able to sustain the revenue growth rates or the profit margins of its glorious past.

On the brighter side, tech's spread into emerging markets could have a snowball effect on the world economy and the

PRICING



There's pressure on prices, so some companies are using pay-as-you-go schemes. Poland needed to modernize its drivers' licensing

system but couldn't afford it. So Hewlett-Packard agreed to install Poland's new computer system in exchange for a cut of the fees drivers pay each time they get a license or renew an old one.

BUSINESS DEVELOPMENT



The old strategies may not work anymore, so companies are trying new ones. IBM figures it can do well in China by supplying technology to local companies.

Example: It developed a low-cost, \$12 microprocessor and a simple network computer for China's Culturecom, which is selling computers and Net-access services in the country's rural backwaters.

COMPETITION



Companies like Cisco, Dell, and Microsoft dominate in the developed world. But now a host of new challengers are using their low costs and

intimate knowledge of local markets to give the giants trouble. Chinese networking upstart Huawei can charge 50% less for gear than Cisco, and is starting to make inroads worldwide.



RUSSIA

The nation's large companies are beginning to see the point of investing in information technology

RAPID TRANSITION
Russian Railways' Belova works for a recently wired giant

tech industry's fortunes. Investments in technology stoke national economies—boosting productivity, gross domestic product, and consumption of all sorts of products, including more technology. And as computer-factory workers in China and software programmers in India increase their incomes, they become consumers. A.T. Kearney figures that the number of people with the equivalent of \$10,000 in annual income will double, to 2 billion, by 2015—and 900 million of those newcomers to the consumer class will be in emerging markets. “If you have a middle class that provides a sufficient market for consumer goods, you have the basis for rapid industrial expansion and jobs for poor people,” says Sarbuland Khan, head of the information-technology task force at the U.N. “It becomes a virtuous cycle rather than a vicious cycle.”

Strategic Rethinking

CINTIA ARANTES and Eduardo Severino de Santana are the embodiment of that hope. The Brazilians, both 22, grew up poor in Recife, on the country's northeastern coast. But both are climbing the social ladder thanks to a local program that trains disadvantaged Brazilian youths in computer skills. De Santana, who had been unemployed last year, quickly turned one computer course into a job helping to manage the tech facilities at a national law firm.

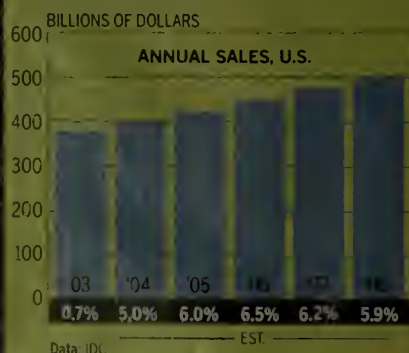
Arantes' trajectory could take her even higher. Her laborer father doesn't have steady work, so she helps support the family of six by working nights at a phone company call center. Thanks to a tip from a teacher at a school where she was an administrative assistant, she started taking computer courses last year. Now she's an intern at a local software company in the mornings, takes courses in the afternoon, and hopes to enter a university computer engineering program next year. Her goal: to become a programmer. “I'll keep on battling until I get there,” she vows. In the meantime, she's trying to save up the \$700 or so it would cost to buy a PC.

In many cases, tech companies will only succeed in emerging markets if they're willing to ditch the strategies that made them successful in the developed world. Take Dell. In 2000 it introduced a consumer PC in China, called SmartPC, that was different from any it had sold before. It came preconfigured rather than built to order, and it was manufactured not by Dell but by Taiwanese companies. At less than \$600, the SmartPC has helped Dell become the top foreign supplier in China. Its share of the PC market there rose from less than 1% in 1998 to 7.4% today.

Still, Dell is anything but the dominant force in China that it is in the U.S. A key reason is that Dell's practice of selling direct to customers, over the Net or the phone, doesn't work very well in the Middle Kingdom. Chinese typically want to lay their hands on computers before they buy them. That means the best



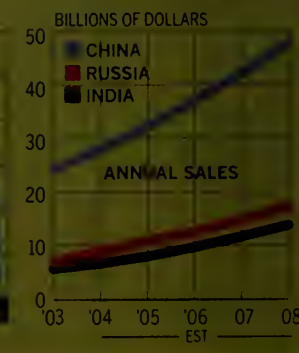
Tech sales growth in developed markets like the U.S. has slowed...



...while emerging-market demand is going strong...



...and some countries' growth is soaring



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Hope, Triumph, and the Miracle of Medicine

way to reach them is via vast retailing operations—the strength of local players Lenovo and Founder Electronics, which both rank ahead of Dell with market shares of 25.7% and 11.3%, respectively, according to IDC. Dell set up kiosks to demonstrate its SmartPC and other products. But in August, the company withdrew from the consumer market in the face of competitors selling stripped-down PCs for as little as \$362. “In the fastest-growing large market in the world, the local PC makers are winning,” says Philippe de Marcillac, a senior vice-president at IDC.

Cultural Customization

THERE'S NO EASY FORMULA for selling in emerging markets. Some corporate or government customers in Russia and Brazil are as big as any in the U.S., and their needs are just as sophisticated. Russian Railways, with 1.2 million employees, spent \$2 billion over the last three years building a modern data communications system. “We’re very proud,” says Anna Belova, deputy minister of the railway. “We have a huge scale of tasks, and we find creative solutions.” Now other giant Russian enterprises see it as a role model and are boosting their tech purchases, too.

To target innovations that will resonate in these markets, companies are conducting in-depth studies of peoples’ needs. Intel, for instance, has a team of 10 ethnographers traveling the world to find out how to redesign existing products or come up with new ones that fit different cultures or demographic groups. One of its ethnographers, Genevieve Bell, visited 100 homes in Asia over the past three years and noticed that many Chinese families were reluctant to buy PCs, even if they could afford them. Parents were concerned that their children would listen to pop music or surf the Web, distracting them from school work.

Intel turned that insight into a product. At its User-Centered Design Group in Hillsboro, Ore., industrial designers and other specialists created “personas” of typical Chinese families and pasted pictures that Bell had taken of Chinese households on their walls. They even built sample Chinese kitchens—the room where a computer is most often used. The result: Late this year, Intel expects a leading Chinese PC maker to start selling the China Home Learning PC. It comes with four education applications and a physical lock and key that allows parents to prevent their kids from goofing off when they should be studying.

Many products designed for consumers and small businesses in emerging markets will have to fit some demanding specifications: They need to be simple to use and capable of operating in harsh environments. A handful of products have already come out with these factors in mind—and many more are on the way. India’s TVS Electronics Ltd., for instance, is selling a new kind of all-in-one business machine called Sprint designed especially for that country’s 1.2 million small shopkeepers. It’s part cash register and part computer, designed to tolerate heat, dust, and power outages. The cost: just \$180 for the smallest of three models.

Pricing is often the make-or-break factor. In rural South Africa, where HP has set up a pilot program similar to the one in India for developing technologies for poor people, the aver-

age person makes less than \$1 a day. Clearly, not too many can afford to buy their own personal computers. HP’s solution? The 441 PC (as in four users for one computer). It’s a machine set up in a school or library that connects to four keyboards and four screens, so multiple people can get on the Net or send e-mail at the same time.

Some of the best ideas for the developing world have the potential for catching on everywhere—including the U.S. It’s already starting to happen. Kishore Kumar first developed a simple PC-based remote health-monitoring system for distant villages in his native India. Now his company, TeleVital Inc. of Milpitas, Calif., is marketing the technology in the States. The first U.S. customer, Battle Mountain General Hospital in Battle Mountain, Nev., couldn’t afford patient-monitoring equipment—or people to operate it. Now it’s hooking up with a hospital 100 miles away to track its patients. Says Battle Mountain

UP-AND-COMERS

With the tech action in emerging markets, local players have a chance to become players on the world stage. Here are some bright prospects:

VIDEO GAME GURU
CEO Kim’s NCsoft
is the world leader
in online PC games

administrator Peggy Lindsey: “We in rural America can really use equipment like this.”

When tech companies modify their existing products for emerging markets, they can end up with improvements that have a broader impact. That’s what happened at Nokia Corp. when it set out to reduce the costs of setting up and operating wireless telephone networks. One improvement, called Smart Radio technology, can cut in half the number of signal-transmission sites operators need. Wrap that and other new technologies together, and operators can build networks for up to 50% less than before. Nokia has been rolling out these innovations from Thailand to Peru. DTAC, the No. 2 Thai cellular operator, is installing the new gear around Bangkok. “If this works, we can use this concept to penetrate into much more remote areas up-country,” says Sigve Brekke, the company’s co-CEO.

Dell already has translated emerging-market innovations into

successes in its traditional markets. After SmartPC took off in China, Dell in 2001 introduced a version for the U.S., for the first time going after bargain hunters. A year later, Dell absorbed the SmartPC into its mainstream consumer product line as sales took off. "We try to take some of the best ideas we have seen that are happening in local environments and make it a global product," says Dell Senior Vice-President William J. Amelio.

Dell, Nokia, and other Western giants need all of the innovations they can muster, especially as the field of competition shifts to emerging markets, and they're confronted by a stampede of aggressive challengers. Chinese communications-equipment maker Huawei is giving Westerners fits in its home market, where it has captured a 16% share in the crucial router business, second only to mighty Cisco, according to IDC. And thanks to prices up to 50% lower than rivals', Huawei is expanding everywhere from Russia to Brazil. It already ranks

senior vice-president and now CEO of Symbol Technologies.

Throughout the developing world, new players are popping up like obstacles in a *Super Mario Brothers* game. Take the online game business itself. Upstart NCsoft has taken advantage of Korea's lead in broadband penetration to build the world's largest online game business, with more than 5 million monthly subscriptions. NCsoft CEO Kim Tack Jin is now expanding in Taiwan, China, Japan, and the U.S.—where 228,000 copies of its *City of Heroes* game were sold in the first three months after its April release, according to market researcher NPD Group. The key to NCsoft's success: It has come up with a combo of fantasy and action gaming that's a hit with players.

Even mighty Microsoft is vulnerable to the competitive threats. Linux is emerging as a viable alternative to its Windows in developing markets and could cut into its market share. China, Japan, and Korea are collaborating on a version

of the free open-source software package. A number of governments are considering policies that favor open-source software packages, and one, Israel, has already decided to stop using Microsoft's products. While that affects only tens of thousands of government workers, if other countries take the same path, millions of their employees could end up using open-source software, rather than Windows and Office.

Microsoft doesn't have an answer—at least not yet. In October the company, which declined to comment for this story, will begin to sell a cheaper Windows in Thailand, Indonesia, and Malaysia in an effort to beat back the open-source threat. But it so far refuses to follow suit in China—where it has had four general managers in six years. "Business as usual won't work there. They have to find new ways to do things," warns Jack Gao, who ran Microsoft China from 1999 to 2003 and now heads up software maker Autodesk's China operations.

It may turn out that patience is the most important attribute for tech companies trying to get things going in emerging markets. IBM, after all,

	BUSINESS	GLOBAL EXPANSION
CSOFT	The world's No. 1 seller of online PC games, with more than 5 million monthly subscribers. The South Korean company is predicting revenue growth of 55% this year, to \$221 million, and 70% growth outside its home market.	After taking off in Korea, NCsoft is expanding in Taiwan, China, Japan, and the U.S. China and Japan present the most growth opportunity. In the U.S., its <i>City of Heroes</i> was an instant hit when it launched in April.
EX TIONS	The Indian company, which offers banking software and services, claims the world's top software suite for managing consumer, corporate, Internet, and investment banking. In a slow-growth worldwide enterprise software industry, revenues grew 26% last quarter.	I-flex sells in 108 countries and just inked a \$10 million deal with Banco Du Chile, the largest commercial bank in the country. Prospects are bright: i-flex's Internet-based systems and low-cost Indian programming give it a huge advantage.
MOBILE	A subsidiary of electronics conglomerate TCL Corp., it's one of the top two Chinese handset makers, specializing in moderately priced phones. It recently formed a joint venture with Alcatel to expand into higher-end products.	It's starting to expand into developing markets in Asia, Africa, and the former Soviet Union. Though TCL faces tough competition, its solid position in the No. 1 cellular market gives it a decent chance at emerging as a strong global player.
PERSKY S	Anti-virus software. Founded by Eugene Kaspersky, one of the world's leading experts on computer security, the Russian company's products protect computers against viruses, hackers, and spam. Sales are forecast to grow 50% this year.	Kaspersky is expanding in Europe, the U.S., China, and Japan, targeting consumers and small businesses. With viruses rampant, Kaspersky is well placed to tap growing demand for security products by capitalizing on Russia's renowned programming skills.

No. 2 worldwide in broadband networking gear, says market researcher RHK. "Huawei is being very aggressive," says Cicero Olivieri, director of engineering and planning for GVT, a large telecom company in Brazil.

Momentum Shift

THE MOST SERIOUS CHALLENGE lies ahead. Huawei is pouring money into Internet Protocol version 6, or IPv6, the standard for the next-generation of the Internet that will have more security, speed, and capacity. China is planning to adopt IPv6 more rapidly than any other country in the world. And if Huawei's close ties to the Chinese government help it become the early leader in the technology, it could get the jump on rivals such as Cisco, Alcatel, and Lucent. "The Ciscos of the world will have to change their business models to compete—and try to out-innovate these small, nimble companies," says William Nuti, a former Cisco

has been in Brazil for 87 years. Hewlett-Packard has spent three years establishing pilot programs in India and South Africa, and, finally, they're starting to yield products and to improve the lives of the locals. Take Neelamma, the itinerant photographer. She has become a star in the two-room house with a dirt floor that she and her stonecutter husband, Krishnamurthy, share with his parents and brother. What are Neelamma's dreams? "I want to buy a television and a ceiling fan. And I want to build a small photo studio in my home," she says. One young woman's life and aspirations have been changed by the arrival of technology. Another 1 billion new consumers may not be too far behind. ■

—With Manjeet Kripalani in Bombay, Bruce Einhorn in Hong Kong, Andy Reinhardt in Paris, and bureau reports

BusinessWeek online For a Q&A with the U.N.'s Sarbuland Khan, go to www.businessweek.com/magazine/extra.htm

Sprint to the Head Of the Pack

By following some unusual strategies, the carrier is blowing past competitors

POP QUIZ: WHICH MAJOR U.S. telecom company is going to post the fastest growth this year? True, it's a dismal bunch. The long-distance giants AT&T and MCI are melting like ice cream in a microwave. The Bells SBC Communications, Verizon Communications, Qwest Communications International, and BellSouth are looking at a year of stagnating revenues or meager growth. No, the telecom company with the most juice these days is a former also-ran—Sprint Corp. The Overland Park, Kan., company is pegged to boost revenues 6.5% this year, to \$27.9 billion, according to Stanley. "It's a real mover," says analyst Viktor Shvets of Deutsche Bank Securities Inc.

That Sprint is outshining its peers is a dramatic change in fortune. For years, the company was an afterthought in telecom: the underachieving Midwestern upstart, perennially chasing AT&T and MCI. When the company came to mind, it was often as an acquisition target suited to round out another's portfolio. But even as Sprint's long-distance rivals have



crashed, CEO Gary D. Forsee has deftly guided his carrier through the wreckage. By focusing on wireless services and making a risky bet on leasing its networks to rivals, Sprint has become one of the most powerful players in the troubled telecom business. "We're taking action," says Forsee.

UNORTHODOX CEO
Forsee is pursuing cable partnerships

"We're making bold moves that will keep us in position to be successful."

Now, Sprint has the muscle to do what would have been unthinkable a few years ago: initiate a big-time acquisition. With a market cap of \$28 billion, Sprint could make a run at almost any phone company in the States, except the biggest Bells. It could easily roll up the long-distance business by buying AT&T or MCI, worth \$12 billion and \$5 billion. That's unlikely given the deep troubles at both companies, but a deal to bolster its wireless business is a distinct possibility. Alltel Corp. in Little Rock would add 8 million wireless customers to Sprint's existing base of 17 million. Nextel Communications would add 14 million subscribers, catapulting Sprint

into the same league as giants Verizon Wireless and Cingular Wireless. "That would set them apart and make [the industry] a good three-horse race," says Michael J. Price, senior managing director at Evercore Partners Inc., a New York investment and banking consultant. Although Forsee wouldn't rule the possibility out, he says Sprint doesn't need to make an acquisition.

How Sprint hoisted itself into position to run with the best is a lesson in foresight and discipline. The company made a huge bet on wireless in the mid-1990s, bidding aggressively on government licenses and then investing billions in its network. The result:

Wireless revenues have grown so rapidly that they now account for more than half the company's sales.

Forsee, a longtime Sprint exec who re-

From Also-Ran to **Front-Runner**

Sprint has emerged as one of telecom's strongest players—and could go on the prowl for its own acquisitions. Here's why:

WIRELESS

Sprint's wireless operation has grown so quickly that it will account for more than half of the company's \$28 billion in 2004 revenues. An array of photo, video, and multimedia applications has helped the company lure subscribers and keep existing ones.

DEALS

Sprint is projected to add \$500 million in revenues by letting rivals lease pieces of its network. Virgin Mobile and Qwest, for instance, are using its cellular network to offer wireless service.

BALANCE SHEET

Sprint is slashing net debt from \$17 billion at the end of 2003 to an estimated \$13 billion in 2004. Meantime, it's expected to boost cash from \$2.4 billion last year to \$5 billion this year.

MARKET CAP

Sprint's market cap tops \$28 billion, far outshining AT&T and MCI, at \$12 billion and \$5 billion, respectively. Few experts think Sprint will go after either of the ailing companies, but it could pursue others, such as Nextel and Alltel.

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joined the company last year after a four-year stint at BellSouth Corp., is building on that foundation. The 54-year-old is striking deals to let other companies lease Sprint's wireless network and then market their own services. Already, Virgin Mobile is buying wholesale service from Sprint and has targeted the youth market to become the fastest-growing wireless company in the U.S. Qwest resells Sprint service. And longtime rival AT&T will begin to use Sprint's wireless network after Cingular closes its deal to buy AT&T Wireless this fall. Those partnerships brought in 300,000 subscribers in the second quarter, nearly two-thirds of its total net additions. "To be successful, we have to be sure that we are taking full advantage of our assets," Forsee says.

RIDING SHOTGUN

IN PERHAPS ITS most unconventional move, Sprint is teaming up with cable operators to deliver voice service to residential customers. Sprint already has a local phone business with 8 million lines in small cities stretching from Lady Lake, Fla., to Hood River, Ore. But that's only 5% of U.S. customers. To reach the other 95%, Sprint is riding shotgun with cable players such as Time Warner and Mediacom Communications as they begin to deliver phone service over their cable pipes. Time Warner provides the link to the home and Sprint the expertise to enable customized voice mail, call forwarding, and operator assistance. Sprint gets a flat fee from every customer the cable companies sign up.

The real prize may come from future services Sprint hopes to offer through the cable partnerships. The company plans to persuade these cable customers to buy Sprint's cutting-edge wireless services. That would include letting customers preview movies on their wireless video phone on the commute home and then place an order to download the movie so it's waiting as they walk in the door. That's a nifty vision of the future. But is it realistic? Even Sprint COO Len J. Lauer concedes: "We don't have the cable companies' full agreement. This is our concept, what we'd like to do."

Take it as a sign of the new Sprint. Lauer and Forsee understand that the winners in telecom won't be those standing idly by. Whether it's launching services—or perhaps making an acquisition—the onetime laggard is now in position to lead the way. ■

—By Roger O. Crockett in Overland Park, Kan.

Playing as Rough As Linebackers

The controversial Poston brothers are rewriting the rules on NFL salaries

IN HIS suburban Detroit home, sports agent Kevin D. Poston displays a gallery of family photos dating back to the days when his ancestors were slaves. One of his favorites is a picture of his great-grandfather Zachary Taylor Winston, who was born into slavery and rose to become a businessman and property owner. "He couldn't write," Poston says. "He signed his name with an X."

These days, Kevin and his brother Carl C. Poston III get their star-athlete clients to sign next to the X—and in the process score some of the richest contracts ever seen in professional football. The brothers are partners in Professional Sports Planning Inc. (PSP), which negotiates deals for more than 40 players, mostly National Football League stars. Their clients include Kellen Winslow Jr. of the Cleveland Browns, Charles Woodson of the Oakland Raiders, and Charles Rogers of the Detroit Lions.

SWEET PACKAGES

FEW SPORTS AGENTS make life as expensive—or as uncomfortable—for the NFL as the Postons do. To get their way, the Postons play rougher than a blitzing linebacker. They want nothing less than to tear down the NFL's feudal salary system. The brash brothers typically represent linemen, defensive backs, and other players who traditionally have earned far less than star quarterbacks. When quarterback Peyton Manning (not their

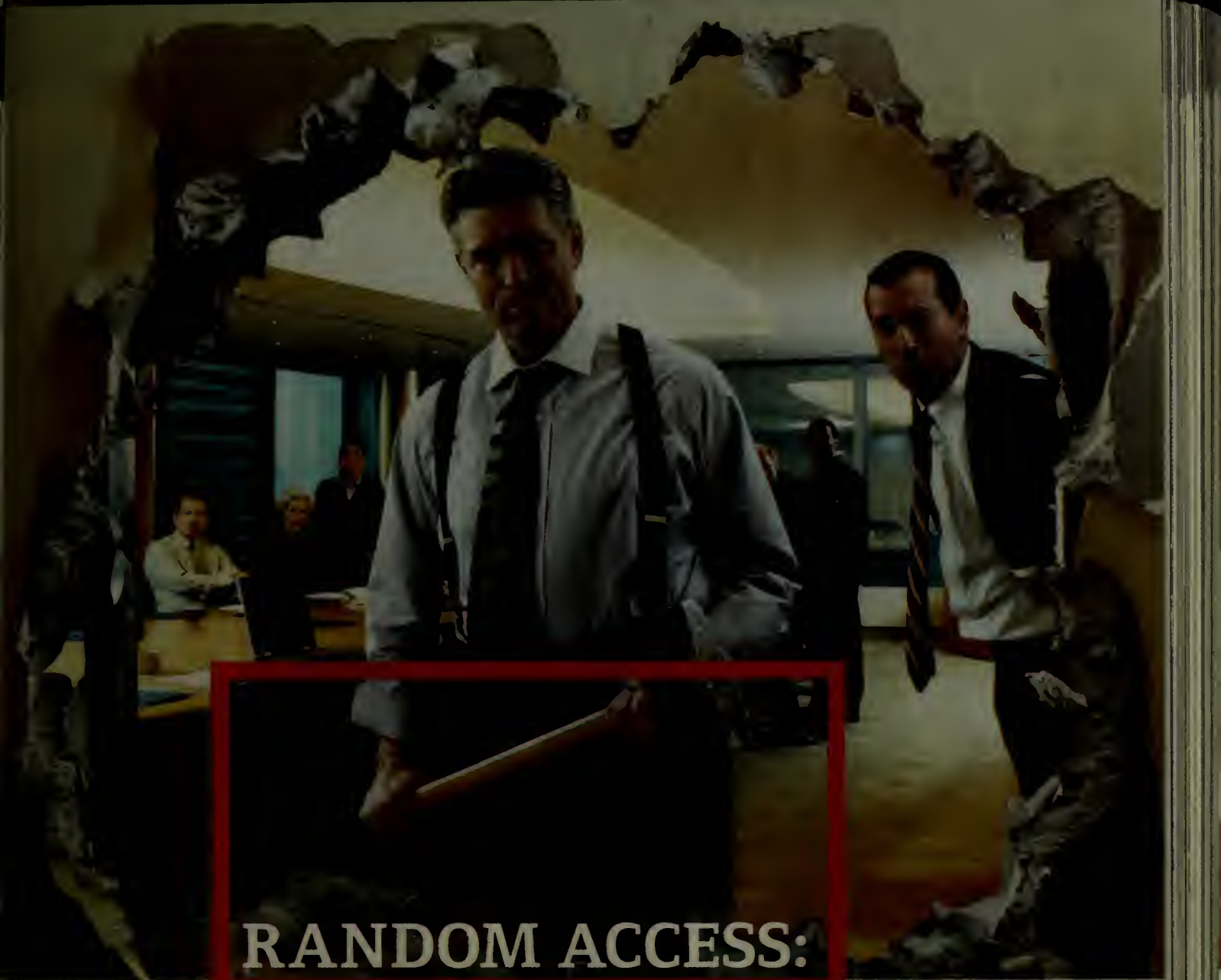


client) of the Indianapolis Colts nabbed a seven-year \$98 million contract this

CARL POSTON His firm, PSP, usually takes a 3% cut of deals its players sign

year, with a smashing \$34.5 million signing bonus, the Postons started making noise about getting "fair market value" for less visible players.

Sometimes they don't do too badly. This season, for example, PSP negotiated a six-year \$40 million deal, including a \$16.5 million signing bonus, for tight end Winslow, the No. 6 pick in the NFL draft. That's a sweeter package than three of the players drafted before Winslow were able to land. But their tactics also can backfire: According to the NFL Players Assn., they recently got dropped by a key client, tackle Orlando Pace. This was the second year running that the Postons failed to negotiate a long-term deal for Pace. The brothers—



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Sports Business

who as *BusinessWeek* went to press said Pace hadn't yet told them he was leaving—are said to have demanded \$71 million from his team, the St. Louis Rams, leading to a standoff. They also failed to negotiate record contracts for two other marquee players, the Raiders' Woodson and San Francisco 49ers linebacker Julian Peterson. When those teams balked at the Poston proposals, the brothers held the players back from preseason training camps. The Postons won't say how much they were demanding, but NFL insiders say they asked for "Manning money."

Hogwash, says Kevin, 45, who works from his home in Farmington Hills, Mich., outside Detroit, a time zone away from Carl's office in Houston. "I never said: 'Give me Peyton Manning money.' I did say Julian was the quarterback of that defense," he says. In the end, the agents failed to reach midfield with Woodson and Peterson. They eventually slinked back to work, just in time for the season to start, after being saddled with "franchise tag" status. As such, they'll be paid the average salary of the top five at their position. It's not a bad consolation prize—\$8.8 million for a year's work, in Woodson's case—but the Postons are still trying to negotiate long-term contracts.

TOO CONFRONTATIONAL?

THE ACRIMONIOUS SUMMER fed the growing perception in the NFL that the Postons consider no salary demand too stratospheric. "Their style is almost a take-no-prisoners approach," says Kenneth L. Shropshire, director of the Wharton School's Sports Business Initiative. Shropshire, an adviser to the family of Poston client Winslow, thinks that can work to a client's advantage. But other agents accuse the Postons of being needlessly confrontational. And NFL execs—many of whom declined to talk about the Postons—now avoid players represented by the controversial agents, insiders say. Many believe that "Poston fatigue" was a factor in the Washington Redskins' decision to pass on Winslow. The team won't comment.

The Postons can shrug off the criticism. Their firm usually takes a 3% share of each deal its players sign, earning them millions in fees. They've come a long way, especially since they got into the business serendipitously. Carl was practicing law in Houston in 1989 when a friend referred a



Houston Oilers football player who had a tax problem. At about the same time, Kevin, also a lawyer, was working on financing for a new basketball arena outside Detroit. They decided to try their hands as agents, printed up a brochure, and began a tour of NFL tryouts, college stadiums, and the living rooms of prospects such as defensive back Terrell Buckley, their first star client.

The brothers never doubted their competence, having acquired a sense of confidence as children in Saginaw, Mich. Unlike many of their friends, the Postons grew up valuing education and business ownership. Their father, Carl Poston Jr., now 81, was a lawyer and one of the first

LOCAL HEROES

Kevin Poston (left) with Charles Rogers of the Detroit Lions

blacks on the Saginaw City Council. His wife Thelma, 74, was the first black to earn a real estate license in the Saginaw area, say Kevin and Carl.

For the most part, the Postons inspire intense loyalty among clients. Pace apparently got restless. But others look to them as older brothers and seek their advice about everything from girlfriends to cars. Carl's cell phone rings nonstop with calls from players checking in. "You're getting a haircut? Nice life," chides Carl when Woodson calls. A few minutes later he is joking with defensive back Ty Law. "I can talk to Carl and Kevin about issues in my life,"

Law says. "They're like my family."

Still, controversy dogs the Postons with each new deal. Redskins star linebacker LaVar Arrington, another client, is ensnared in an arbitration over whether the team negotiated one contract and then—unbeknownst to Carl, he says—slipped Arrington another to sign, minus a \$6.5 million bonus. "If the agent admits he didn't read the contract, that's worrisome," says one player rep who asked not to be named. Carl says he's confident that Arrington will prevail in the arbitration. Arrington stands by the Postons.

Then there's the race question: All of the Postons' clients are African American, leading some Poston-bashers to speculate that PSP prefers to represent only blacks. Such talk mostly amuses the Postons. "We'd love to represent [white stars] Peyton Manning and Zach Thomas," says Carl, 49. "We don't get the time of day from white players and their families."

Even so, the Poston empire continues to expand. This year PSP added two first-round draft picks: Jacksonville Jaguars wide receiver Reggie Williams and Chris Gamble of the Carolina Panthers. In a field where success is measured in greenbacks, it seems no amount of controversy will stop these brothers from reaching the end zone. ■

—By Mark Hyman in Houston

**St. Louis
Ram
Orlando
Pace:
Dropping
the
Postons?**



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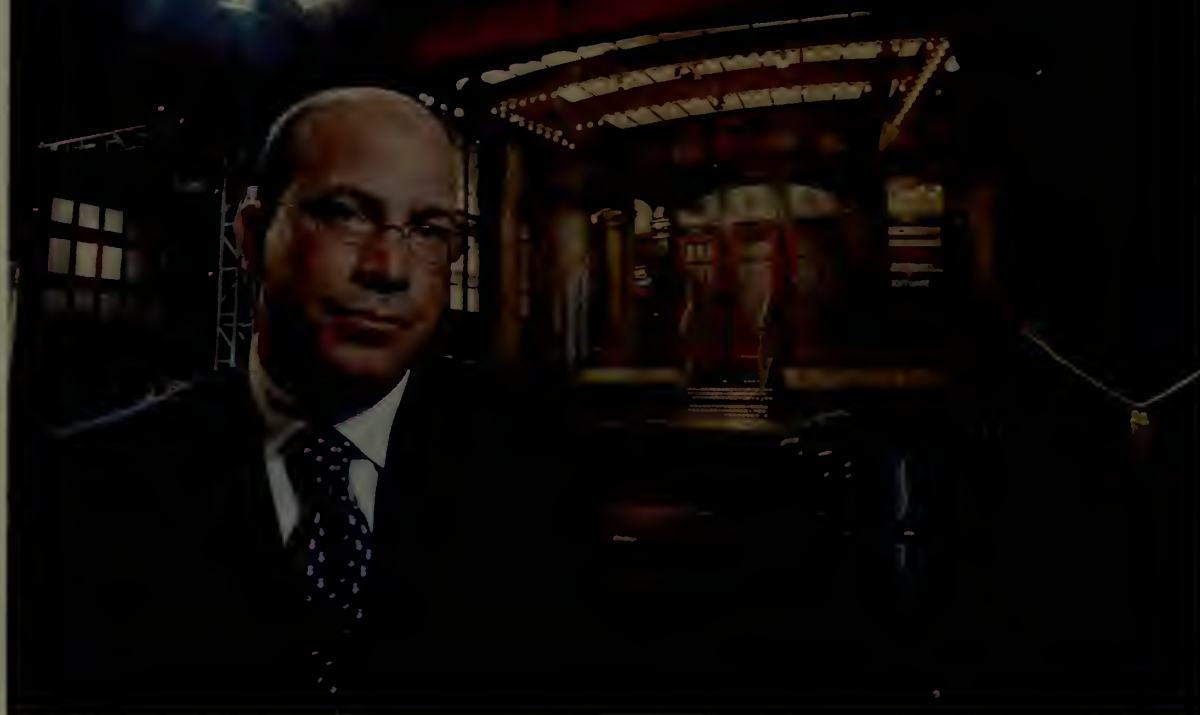


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AT SATURDAY NIGHT LIVE

The TV chief is a top prospect to succeed CEO Bob Wright



Jeff Zucker: Life Without *Friends*

Keener competition means he'll have to work harder to keep NBC No. 1

JEFFREY ZUCKER IS ON A tear. It's early September, and the president of General Electric Co.'s NBC Universal Television Group is gearing up for the new season. He has been at his desk at NBC's New York office since 7 a.m., chatting up Katie Couric and Matt Lauer at the *Today Show* and making calls to execs in New York and Burbank, Calif. The 39-year-old executive has spent his entire career at NBC, but he's facing his biggest test yet: a season without the hit show *Friends*, at a time when rival networks are gunning for NBC. The brash Zucker shows no signs of worry, though. "We've been No. 1 so long that the only news in

town is that we're under attack," he says. "I get that. But there's a reason why advertisers gave us more money than any other network last year."

With his track record at NBC, it's no wonder Zucker is so cocky. As a 26-year-old executive producer for the *Today Show* in '92, he resurrected its ratings with gimmicks such as outdoor rock concerts. After being named president of NBC Entertainment in 2000, Zucker kept the network ahead of the pack by airing eyeball-eating contestants on the gross-out show *Fear Factor*, squeezing extra years out of the *Friends* crew, and signing Donald Trump for the reality show *The Apprentice*. The Zucker era has produced a hefty spike in operating earnings for the NBC

network, from \$532 million the year he took over to \$870 million in 2003. When NBC merged with Vivendi Universal, Zucker's responsibilities, which already included NBC's cable channels, were expanded to include TV production as well as the USA, Sci-Fi, and Trio cable channels.

In a post-*Friends* world, however, Zucker is in a much tighter race. Last season, NBC scratched out a narrow 3% of a ratings-point lead over Fox among the 18-to-49-year-old viewers whom advertisers crave—proof that the network could use a barrel of fresh

hits to keep its lead this season. And NBC's newest shows have been disappointments so far. *Friends* spin-off *Joey*, starring Matt LeBlanc, opened to solid but unspectacular ratings. The jury is still out on animated sitcom *Father of the Pride*. Even the mighty Donald is weakening: *The Apprentice*'s ratings for the first episode were down 27% from last season among 18-to-49-year-olds, according to MediaWeek's Programming Insider. Zucker says ratings are often off in September.

PROMOTE, PROMOTE

NBC IS STILL NO. 1, but as rival networks begin to roll out their fall schedules, the Peacock is getting squeezed on all sides. Fox has scheduled its hot teen drama *The O.C.* against *Joey*. And CBS has scheduled its new crime drama *CSI: New York* against NBC's perennial hit *Law & Order* on Wednesdays. Zucker's bosses will probably be watching carefully to see if the young executive can fend off the assault. Zucker is considered a likely successor to NBC Universal Chairman and CEO Bob Wright, 61, who could retire in a few years. "Given his age and accomplishments, Jeff has to be one of the lead candidates," says Ron Meyer, chief of Universal's film studio. A failure this season, however, could be a black mark.

Zucker is certain that his tried-and-true game plan will come through for him. He seeks out shows that appeal to



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18-to-49-year-olds and those with incomes of \$75,000 or more. Then he promotes them relentlessly. This season he launched several new shows more than two weeks before his rivals, playing off NBC's heavily watched Olympics coverage, which featured endless commercials for NBC's fall season.

Promotion is a Zucker trademark. When *Friends* and *Frasier* were about to go off the air, the network ran numerous prime-time specials to hype the finales. It worked: *Frasier* had its best showing in the ratings since 2000, and the *Friends* finale was second only to the 2004 Super Bowl in drawing viewers. Even when he gets beat, Zucker fiercely defends the NBC franchise. When Fox hustled its boxing reality show *The Next Great Champ* on the air ahead of NBC's *The Contender*, Zucker publicly lambasted Fox for stealing the idea. "They used to be innovators, and now they're imitators," he said, setting off a firestorm of protest. Never mind that NBC's own *Last Comic Standing* is a comedy version of Fox's *American Idol*. "Those are different," says Zucker. "We did not steal a show that was someone else's idea and rush it out ahead of them." Fox network President Gail Berman responded: "No one can claim sole ownership to an entire area."

EARLY PUSH

ZUCKER HAS always been ultracompetitive. As a boy in North Miami, Fla., he hated losing at any sport. "When we played tennis, he had to get the best tennis coach in the city so he wouldn't be embarrassed," recalls childhood friend Ken Bernstein. Zucker went on to become a top-ranked tennis player in Florida, says Bernstein. The 5-foot, 6-inch Zucker also served as president of his sophomore, junior, and senior classes, running

He ran for class president as "the little man with the big ideas"

covered sports for *The Harvard Crimson*. He later became president of the publication. It was at Harvard that Zucker first met Conan O'Brien, now an NBC late-night host, who worked for humor magazine the *Harvard Lampoon*. As a prank, O'Brien's staff stole all the *Crimson* issues one day before they could be delivered. Zucker called the cops. "My first meeting with Jeff Zucker was in handcuffs, with a Cambridge police officer read-

on the slogan "The little man with the big ideas."

Too small to pursue his fantasy of playing football for the Miami Dolphins, Zucker took to writing local sports stories for *The Miami Herald*. He continued his writing career as an undergraduate at Harvard University, where he

ing me my rights," says O'Brien.

That combative nature has fueled Zucker's staggeringly quick climb to the top at NBC. After failing to get into Harvard Law School, he delayed his legal studies at the University of Virginia to do research for NBC's 1988 Seoul Olympics coverage. He was recruited to the *Today Show* in 1989 and in 1992 was named executive producer. More recently it was Zucker who nabbed *The Apprentice*. "ABC had us—but were nickeling and diming us," says Trump, a co-owner of the show. "Jeff locked us in a room until we had a deal."

There was no easy way around Zucker's toughest opponent: colon cancer. Diagnosed at age 31, he had a large part of his colon removed, then endured more than a year of chemotherapy. He was so deter-

mined not to be sidelined by the disease that he scheduled his chemo on Fridays so he could be back at his desk each Monday. Zucker's cancer is in remission, but he still thinks about its impact. "It put my life into perspective," he says. "I want to win and win honorably. But heck, it's only

television." Today, Zucker is careful to make time for his wife and three children and often blows off steam by playing golf and tennis.

Back in his New York office, Zucker is focused on winning in the ratings this season. He hasn't pulled out all his tricks yet. For example, NBC is preparing a fourth version of *Law & Order*, called *Trial by Jury*, which likely won't air until early next year.

"We're like the New York Yankees," Zucker says. "In the end, we're always on top." Maybe so. But he'll need a few home runs to maintain NBC's No. 1 spot in this year's ratings—not to mention his own meteoric rise. ■

—By Ronald Grover
in New York

BIG BETS Ratings for *The Apprentice* and *Joey* have been disappointing so far



BIO

Jeff Zucker

His rise at NBC is legendary. Can he keep up the momentum?

BORN Apr. 9, 1965, Miami

EDUCATION B.A., American History, Harvard College, 1986.

CURRENT POSITION President, NBC Universal Television Group.

CAREER PATH Joined NBC in 1986 as a researcher for the 1988 Olympics, went to *The Today Show* in 1989 as a producer and became the youngest executive producer in *Today Show* history in 1992, at age 26. Named president of NBC Entertainment in 2000 and given expanded duties over NBC's news and cable operations in 2003. In May, 2004, promoted to current position

after NBC's merger with Vivendi Universal.

BIGGEST MISTAKE Ordered a remake of the racy British sitcom *Coupling* as a potential successor to *Friends*. It was axed after four episodes.

BEST CATCH Beat out other networks to sign a deal with *The Apprentice* producers Mark Burnett and Donald Trump for a costly \$2 million per episode. The show turned around the network's season last year, keeping NBC No. 1 among the coveted 18-to-49-year-old segment.

COMPETITIVE STREAK

Once ordered an NBC helicopter to buzz around loudly during an outdoor concert for ABC's *Good Morning America*.

FAMILY Married to former *Saturday Night Live* producer Caryn Nathanson; three children.



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What Makes Jon Corzine Run

His rise in the Senate has been meteoric—so why is he aiming to be governor of Jersey?

WHEN DEMOCRAT Jon S. Corzine spent \$60 million of his \$300 million-plus fortune to move from Wall Street to Capitol

Hill in 2000, he doubled the previous record for spending on a Senate race. Critics dismissed Corzine, formerly co-chairman of Goldman, Sachs & Co., as a dilettante politician with an expensive midlife career crisis. But that was then.

Today, Senator Corzine, respected in Washington and popular at home, is the automatic front-runner to become New Jersey's next elected governor in November, 2005. That race is already under way because of Governor James E. McGreevey's August announcement that he will resign in the wake of a scandal over allegations that he appointed an unqualified man with whom he was having an extramarital affair to a sensitive state job.

Corzine's money no longer counts

against him: His whatever-it-takes campaign spending will discourage challengers, and independent wealth is viewed as a plus in his state's often-disreputable politics. "New Jersey voters

STREET SMARTS:

Financial expertise put him out front in the corporate scandals

swoon over old money because they figure that personal wealth puts politicians

above corruption," says political scientist Ross K. Baker of Rutgers University. A couple of years in the governor's mansion could even position Corzine for a run at the White House in 2008.

It's a different career path than the bearded 57-year-old had in mind. Until McGreevey's announcement, Corzine was building his political credibility among fellow Democrats in Washington. As head of the Democratic Senatorial Campaign Committee, he has matched the GOP by raising nearly \$60 million under stringent new fund-raising limits. He's also credited with recruiting strong candidates—such as former Colorado Attorney General Ken Salazar and former Alaska Governor Tony Knowles—for Senate races in traditionally Republican states.

Even if the Democrats fall short in their quest to retake the Senate (page 101), Corzine will have won chits across the nation. "He took one of the toughest and most thankless jobs in congressional leadership and came from behind to make the Democrats competitive," says Jennifer Duffy, a Senate analyst for the nonpartisan *Cook Political Report*.

Luck and timing have also helped Corzine make his mark swiftly in a tradition-steeped forum where neophytes are expected to know their place. In the midst of the rogues' parade of corporate and accounting scandals of the past three years, Corzine—though a junior member of the Senate Banking Committee—has emerged as the Democrats' authority on financial regulation. As the only former Wall Street CEO in Congress, he also pro-

Corzine on the Record

ON BUSH'S OWNERSHIP SOCIETY:

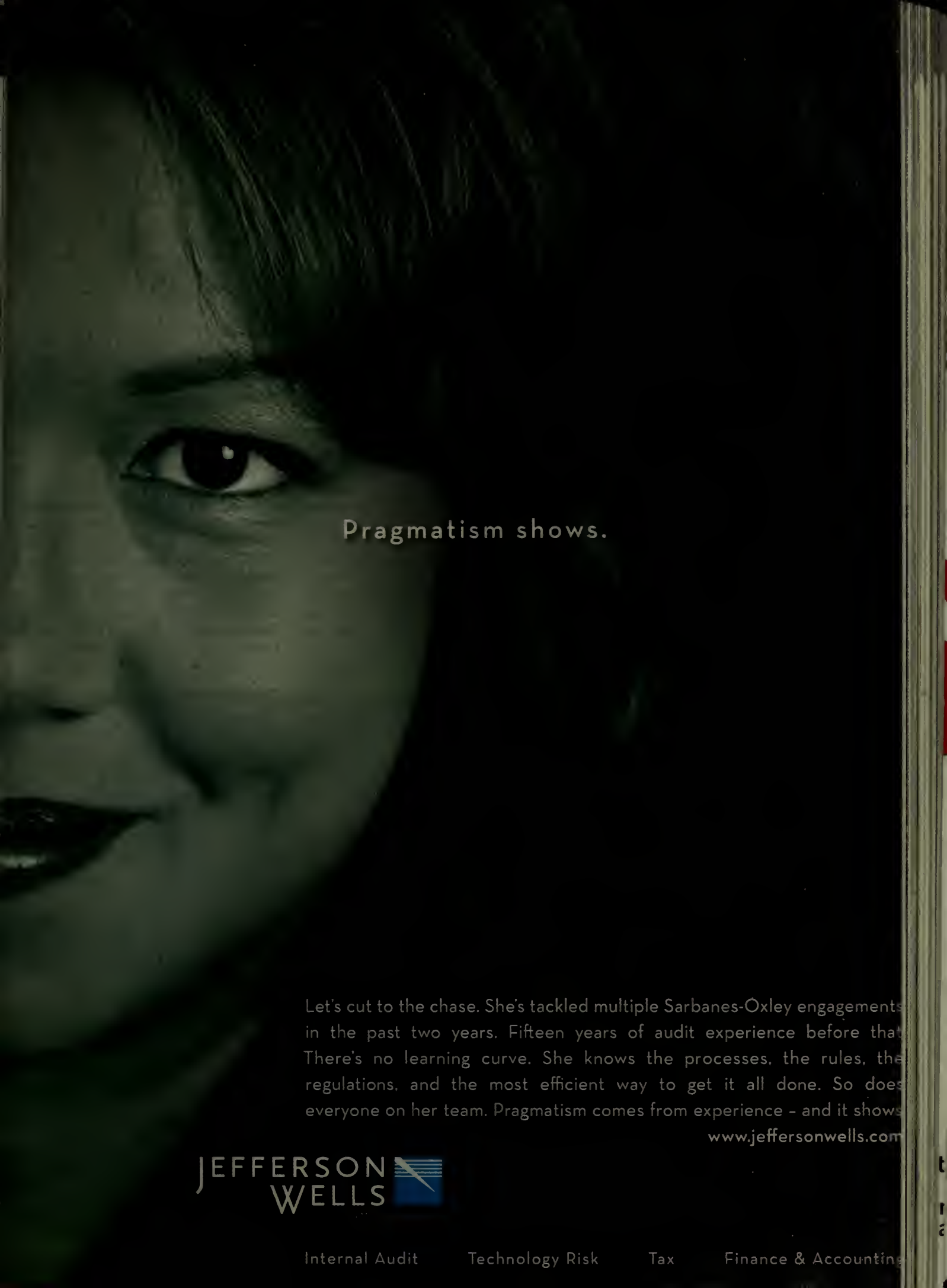
Ownership society is a Madison Avenue term. Of course, if you believe in capitalism, you believe in ownership. It's motherhood and apple pie. That doesn't mean that you want to instantly go to gutting Social Security as a safety net for seniors."

ON TAX CUTS:

I'm a very mainstream conservative with regard to fiscal policy, including, by the way, not supporting tax cuts that I think we can't afford at a time of war. ... I'd like to have dividends treated the same way as capital gains. But you have to have priorities. And we are running huge budget deficits."

ON GOING TO WAR IRAQ:

[The Administration] made no case that anybody in business would have accepted or any credit committee or any capital committee that I ever sat on [would have accepted]. It was all assertion."



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vides other Democratic members cover by backing stronger regulations on 401(k)s and hedge funds and advocating tough enforcement powers for the Securities & Exchange Commission.

But the topsy-turvy politics in Trenton have refocused Corzine's political ambitions in a hurry. Although top state Dems urged McGreevey to resign immediately so a successor could be picked in a special election this November, he declined to step down until after Sept. 3. Under state law, that ensured that the job would go to New Jersey Senate President Richard Codey until 2005. So why would Corzine, who has served less than one full term, want to leave the august Senate? "I was an executive most of my life," Corzine tells *BusinessWeek*. "Having the ability to set the agenda and fight for that agenda" is more satisfying than the struggle to pass legislation. That's especially true when you are a member of the Senate's minority party.

MAKE-OR-BREAK MOVE

FIXING WHAT AILS New Jersey would give Corzine a résumé tailor-made for the national stage. But talk of a run for the White House is premature, he insists. And if there is a downside to Corzine's chances nationally, it could lay with his left-of-center politics. He opposed the Bush tax cuts—"they gave us deficits without economic stimulus"—and voted against lucrative farm subsidies. Those stances might not play well in Iowa or New Hampshire. Another potential problem: the image of Corzine as a moneybags politician. With millionaires making up 40% of the Senate, "My problem with Corzine is that he is a symbol of a very disturbing trend," says Charles Lewis, founder of the Center for Public Integrity, a Washington watchdog group.

Corzine insists that voters don't care how he finances his races. And if Governor Corzine succeeded even marginally in eliminating the sleaze from Jersey politics, his reputation as a reformer would overshadow a liberal voting record in the Senate.

A few years spent cleaning up and running the nation's ninth-largest state could make Corzine a national star. Or a stint in a capital beset with corruption and grueling fights over school funding, auto insurance, and state pensions could do for Corzine what it has done for so many other aspiring Jersey pols—dash any hopes of higher office. ■

—By Paul Magnusson in Washington

Democrats: A Hill Too Far?

Two seats short of a Senate majority, the party now faces a risk of backsliding

NOT SO LONG AGO, Democrats were bragging that they could win back the Senate this November—and it didn't seem like bravado. The party had recruited a bumper crop of candidates who were leading in early polls. Republicans were mired in nasty primary contests. The economic recovery seemed to be stalled. And Senator John Kerry was riding high—giving Dems a lift even in some traditionally Republican states.

Now, those boasts have been replaced by stony silence and white knuckles. The Republican primaries, instead of producing scarred survivors, have mostly created battle-tested warriors with general-election appeal. The economy, while not exactly sizzling, is clearly on the upswing. President George W. Bush, an effective campaigner, appears likely to sport strong coattails in close races from South Dakota to South Carolina—as Kerry's weakened campaign does little to help Democratic contenders. And an energized GOP base will boost turnout in the Republican-leaning states where most of the key Senate races are being waged, including five in the South. "The Democrats have good candidates," says Stuart Rothenberg, editor of the nonpartisan *Rothenberg Political Report*. "They are just in states that are bad for them."

This new reality means lower expectations for the out-of-power party. Just two senators short of a majority, Democrats are now playing defense. Nightmare scenario: a loss of up to four seats. That kind of a setback could dramatically change the Senate. A bigger GOP majority would break the logjam on Bush's long-stalled judicial

appointees and force through reforms on product-liability lawsuits.

The Senate's tone would change, too. At least two of the top GOP prospects are former foot soldiers in Newt Gingrich's conservative House revolution—and they would likely extend that style of smash-mouth partisanship to the more sedate Senate. Departures of centrist Democrats, such as retiring Louisiana Senator John Breaux, will leave the middle emptier than ever. "The polarization we sense this election year could be pro-

TOUGH TASK Dem Attorney General Salazar faces beer scion Pete Coors



longed in the U.S. Senate, as it already is in the House," says politics professor Ferrell Guillory of the University of North Carolina at Chapel Hill.

While Bush's poll numbers have captured headlines and set off speculation about his possible coattails, the GOP's Senate hopes are really riding on the quality of its candidates. In Pennsylvania, Democratic hopes sagged when Republican incumbent Arlen Specter survived an aggressive primary challenge from Patrick D. Toomey. Archconservative Toomey would have had a tough time against centrist Democrat candidate Joseph M. Hoeffel, but the moderate Specter is running far ahead and just collected the endorsement of the AFL-CIO.

HUGGING GEORGE

IN COLORADO, beer scion Pete Coors is widely considered a stronger candidate against popular Attorney General Ken Salazar than Bob Schaffer, Coors's rival in the GOP primary, would have been. In Florida, former Housing & Urban Development Secretary Mel Martinez scored a surprisingly easy win over 2000 Senate loser Bill McCollum, whom White House aides viewed as dull and unelectable. Martinez will take on Florida Commissioner of Education Betty Castor to fill the seat of

retiring Democratic Senator Bob Graham.

Likewise, Oklahoma's firebrand populist Tom Coburn, an obstetrician and former congressman, is more dynamic than the man he defeated in the July 27 primary, former Oklahoma City Mayor Kirk Humphreys. But Coburn's outspoken style and penchant for hyperbole are making D.C. Republicans sweat a bit. He has advocated the death penalty for abortion providers; describes his match-up with Democratic Representative Brad Carson, a member of the Cherokee Nation, as a choice between "good and evil"; and now is embroiled in a controversy over possibly illegal billing to Medicaid. Says Kenneth S. Hicks, professor of political science at Rogers State University in Claremore, Okla.: "Coburn can come off as someone who has read too many Ayn Rand novels."

How worried are Democrats about Republican gains? Check out the latest from South Dakota, where Senate Minority Leader Tom Daschle, a leading Bush antagonist, has aired a TV commercial with a shot of the President hugging him. There's good reason for Daschle to belatedly embrace Bush: He knows that the President will carry South Dakota by a wide margin and perhaps carry Republican nominee John Thune to victory—just

as Ronald Reagan did when Republicans ousted another liberal South Dakotan, George McGovern, in 1980.

Voters' brightening perception of the economic recovery appears to be aiding some Republicans. In South Carolina, continuing textile woes are offset by the creation of 31,000 jobs since July, 2003. "It's a case where economic change is working for the Republicans," says John J. Pitney Jr., professor of political science at Claremont McKenna College. After trailing for months, GOP Representative Jim DeMint has pulled ahead of Democrat Inez Tenenbaum.

The Democrats' national ticket can do little to stanch GOP gains. With seven of the eight most hotly contested Senate races located in states Bush carried in 2000, it's no surprise that Democrats like Tenenbaum are increasingly distancing themselves from the standard-bearer. "You'd be hard-pressed to find a Democratic candidate [in the toss-up races] who would want to appear with Senator Kerry," says Earl Black, professor of political science at Rice University.

If the prevailing political climate is damaging to Senate Democrats, it is crushing for their House counterparts. Gerrymandering has left precious few Republican seats in play, and the GOP stands to net as many as seven new seats in Texas in '04 due to a particularly partisan redistricting map jammed through the legislature last year by the state's all-Republican leadership.

Faced with long odds, the Democrats' only hope for winning back the House is an out-of-the-blue Republican collapse. That was improbable even in May, when an Ipsos-Public Affairs poll showed voters favoring Dems to win control of Congress by 50% to 41%. Ipsos's latest poll, conducted Sept. 7-9, shows the sentiment shifting toward the Republicans for a lead of 47% to 45%.

The election is still weeks away, and the public mood could change. And as Oklahoma shows, Senate races are often subject to the vagaries of local—not national—factors. But for now, it appears that the Democrats' uphill climb to win control of Congress is getting steeper all the time. ■

—By Alexandra Starr in Washington



Fading Hopes

Why Democrats' odds for taking back the Senate have worsened:

THE GOP FALLS IN LINE

Republican primaries were less damaging than predicted, allowing stronger candidates, such as Florida's Mel Martinez, South Carolina's Jim DeMint, and Oklahoma's Tom Coburn, to emerge.

BUSH COATTAILS

The President's bump in the polls could prove a boon for GOP Senate candidates in states like South Dakota and South Carolina. Dem rivals, meanwhile, are steering clear of Kerry, fearful that his weak campaign will pull them down.

THE ECONOMY IMPROVES

Better employment and income growth are hurting Democrats' attempt to make issues of jobs, trade, and health care. That's helping the GOP in states like Pennsylvania, where Arlen Specter has been endorsed by the AFL-CIO.

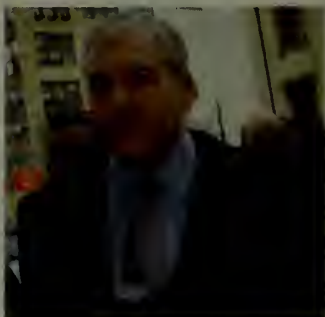
Not So Fast, Lord Black

Investor Chris Browne's persistence put a spotlight on the Hollinger CEO

ON AUG. 30, CHRISTOPHER H. Browne finally got an answer to the question he had been asking for three years. In a 513-page report, a special board committee of Chicago-based newspaper publisher Hollinger International Inc. explained how much the company's longtime CEO and still-controlling shareholder, Conrad Black, and other managers had been paid over the previous years, and what role the board had played in the payments. According to the report, Black and a few others had transferred to themselves from 1997 to 2003 more than \$400 million—95% of the company's entire net income—in what board investigators coined a “corporate kleptocracy.” Black was fired as chairman in January. Now he and the board are embroiled in a court fight over repayment of that money and the company's future that could last for years. Black's company, Ravelston, maintains he and the other managers did nothing wrong and that the report contains numerous inaccuracies and misrepresentations.

Browne is an unlikely figure to have set in motion such a management implosion. A managing director of Hollinger's largest shareholder, New York investment firm Tweedy, Browne Co., he is one of five men running a well-regarded but modest investment firm. They manage \$10 billion in mutual funds and private investment ac-

counts and invest in companies they believe are undervalued by the public markets. But they don't seek to gain control of, or even help manage, distressed companies, as other value investors often do. Their Hollinger stake represents less than 2% of their total assets, and though they owned 18% of the publisher's class A shares, it was Black and his partners who controlled the company through their supervoting stake. Browne never even sought a seat on the board. Says Charles M. Elson, director of the John L. Weinberg Center for Corporate Governance at the University of Delaware: “Until this whole thing happened, I was just not familiar with Tweedy Browne.”



BLACK Some \$25,000 of company cash was for “summer drinks”

Browne and his partners didn't go after Hollinger because they wanted to grab the limelight. “We just asked a question,” says Browne. “That's all we did.” And he kept asking, first in an October, 2001, letter to the independent members of the board. That's the year Browne and his partners noticed that management fees being paid to Ravelston—a firm owned by Black and Hollinger's former COO, F. David Radler—had gone from \$8.5 million in 1996 to \$40 million in 1999, and were still running well above \$30 million a year despite a slump in the business. On top of that, Hollinger had sold off some regional newspapers, and, Browne later found out, Black and other executives were paid tens of millions more in noncompete fees by the buyers.

Browne, who felt those should have gone to Hollinger, questioned the payments at Hollinger's May, 2002, annual meeting in New York, which not a single outside board member attended.

A year later, Browne filed a report with the Securities & Exchange Commission demanding the board look into the suspicious compensation. By Hollinger's 2003 annual meeting, shareholders had been whipped into a furor. Black blasted Browne, depicting his auditors as harassers. And the embattled CEO told questioning investors: “You don't know what you're talking about, but you're still welcome as shareholders.” Browne was undeterred, and Hollinger investors are in his debt. “I think Tweedy Browne's role in Hollinger was intelligent shareholder activism at its very best,” says Leon G. Cooperman, founder of Omega Advisors Inc., also a shareholder in Hollinger.

Browne's step to center stage was not merely a refusal to be cowed. It was also a reaction to a markedly changed corporate-governance environment—one in

BROWNE
Undeterred
by Black's
blasts



ded board, which included Henry A. Kissinger, 9-11 Commission member and former Illinois Governor James R. Thompson Jr., and foreign-policy expert Richard N. Perle. These were people with reputations to protect, after all.

Browne is quick to dispel accusations by Black's supporters that Tweedy Browne intended to spur Hollinger's breakup from the start. The firm—in which Chris's father, Howard, became a partner in 1945—likes to invest in profitable companies trading at no more than two-thirds of their intrinsic value. They began looking at Hollinger in 1999. Hollinger was trading at \$11 a share even though its assets should have been worth \$18 to \$19 a share based on the prices paid in recent newspaper acquisitions. What's more, Tweedy Browne had made money in a previous company run by Black, so the partners didn't hesitate to buy into Hollinger. It wasn't until early 2003 that they started to worry that Black was benefiting at their expense.

ON THE SHAREHOLDERS' TAB

INCLUDED IN THE REPORT that spelled out Hollinger's missteps was a raft of revelations about Black's personal excesses, such as the \$24,950 he spent on "summer drinks" at his cottage in Cottesmore, England. Browne didn't object to Black's high-priced lifestyle, just the fact that he and other shareholders were bankrolling it. "I'm not critical of how people want to live as long as they're spending their own money," he says.

That's understandable—Browne himself lives quite well. Aside from his Park Avenue apartment, with its sweeping views of the city, he has owned a series of homes in the exclusive beachside town of East Hampton, N.Y. Although Browne, 57, grew up the son of a Wall Street broker, he

was not groomed to follow his father's footsteps into finance. "My father almost never talked about work," he says. Browne fell into Dad's business by accident. He had just finished a six-month stint in the Army Reserve in 1969 when he arrived at his father's office to borrow train fare home to New Jersey. His father's partner, Thomas P. Knapp, a friend of Warren E. Buffett's, gave him a two-hour lecture on value investing and invited him to work there for the summer.

Browne was hooked. He spent his early years at the firm buying up banks in Illinois and waiting for the payoff that came through consolidation. As an associate in the 1970s, he pushed to start the money-management business that eventually became the firm's bread and butter. Browne's father died in 1994, but his brother, William, is also a managing partner. Along with three other managing partners, John D. Spears, Thomas H. Shrager, Robert Q. Wycoff Jr., and other staff, they have \$488 million of their own money in the firm.

It's unclear how long Tweedy Browne will keep its Hollinger stock. By challenging Black's rule, Browne helped boost the shares from a low of \$7.70 in March, 2003, to more than \$20 a share in April. They've slid a bit, to a recent \$17, but the firm is still up at least \$77 million on its investment. Not a home run, Browne says, but a vast improvement over the mess that existed before he started asking questions. It just shows that sometimes it pays to speak up. ■

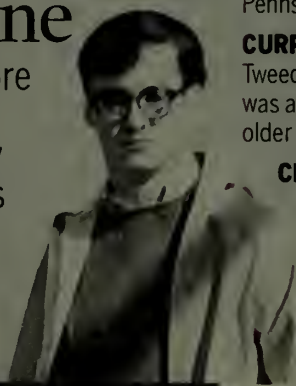
—By Nanette Byrnes in New York

which shareholders, in the wake of Enron, WorldCom, and Tyco International, have become more powerful and boards more pressured to pay close attention to such excesses as stratospheric executive pay. Browne figured he had nothing to lose by pressuring Hollinger's star-stud-

BIO

Christopher H. Browne

Little known before the Hollinger mess, the money manager has lots of fans now



BORN Dec. 19, 1946, Summit, N.J.

EDUCATION B.A., History, University of Pennsylvania, 1969.

CURRENT POSITION Managing director of Tweedy, Browne Co. His father, a stock trader, was a partner at the investment firm. His older brother William is a managing director.

CLAIM TO FAME Taking on Conrad Black, then-chief of Hollinger International, over unexplained pay. In May, 2003, Browne, whose firm owns 18% of Hollinger, demanded a board investigation. That led to the 513-page report filed on Aug. 30



FAMILY PORTRAIT Chris (far left), father Howard (center), and Will (far right)

accusing Black of a \$400 million "corporate kleptocracy."

HOBBIES Buying up land in East Hampton and spending years landscaping and designing his homes. His current project is an 18-acre oceanfront spread, for which he beat out David Geffen by allowing the former owner to remain in the house for six years.

FAMILY Divorced.

British Reserve? Forget That

With American drive, Joe Plumeri aims to make Willis the top insurance broker

JOSEPH J. PLUMERI'S WALL Street career is marked by hard work, brash salesmanship—and a little luck. As a law student seeking part-time work in 1968, Plumeri stumbled into Sanford I. "Sandy" Weill's upstart brokerage, Carter, Berlind, Potoma & Weill—mistaking it for a law firm. Hired as a gofer, Plumeri retired 32 years later as chief executive of Weill's insurance unit, Primerica Financial Services.

Five months later, a vacationing Plumeri ran into buyout specialist Henry R. Kravis of Kohlberg Kravis Roberts & Co. in Paris. Kravis needed a CEO to run insurance broker Willis Group Holdings Ltd., then a recent investment. Plumeri was his man. "I always felt like I was working for somebody else—it wasn't mine," says Plumeri, whose favorite song is Frank Sinatra's *My Way*. "Now it's me."

Sure enough, the 61-year-old Plumeri is doing things his way as CEO and chairman. He has taken a long-languishing 175-year-old British firm and injected a strong dose of American get-up-and-go. Shifting the braintrust to New York from



London since he took over in October, 2000, he has poached nearly 1,000 staffers from rivals, mainly Marsh Inc. and Aon Corp. He rewards hard work with stock options, and now 75% of employees own some stock. He also ordered 33,500 Willis lapel pins (mandatory attire) and made them "bold and ob-

trusive, so people could tell Willis was back on the map." Says analyst Cliff Gallant of Keefe, Bruyette & Woods Inc.: "They are attracting entrepreneurial people who like the idea of building something."

Although the Willis ship is riding high, there's a storm brewing that could rock it and the industry. New York Attorney General Eliot Spitzer's office says it's pursuing "a

vigorous investigation" of Marsh, Aon Willis, and a handful of other brokers. Sources say charges—maybe even criminal—will be filed as early as next month. The probe is looking at whether brokers have a conflict of interest when they funnel more business to the insurer who pays them the highest commissions, rather than the one with the best rates. Neither Marsh nor Aon would comment.

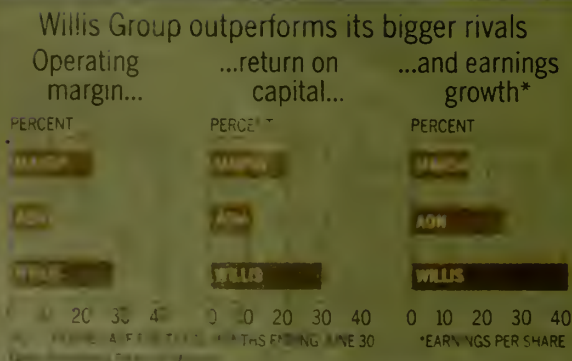
For his part, Plumeri says he's cooperating with Spitzer but he doesn't expect Willis will be harmed. The company generates only a fraction of its revenue from the commissions under scrutiny. J.P. Morgan Chase & Co.'s David S. Sheusi says that even if such commissions are banned, Willis' earnings would fall only 4%. Wall Street expects 2004 profits of \$2.75 a share, vs. \$2.28 last year.

Willis is still a distant third in global insurance brokerage, but that just fires up Plumeri's competitive juices. "If I didn't want to be No. 1, what the hell would I be doing here?" says the son of a working-class Trenton (N.J.) family and the firm's first non-Brit CEO. New York-based Marsh controls 31% of the worldwide market for brokering deals between insurance companies and corporations that need coverage. Chicago's Aon holds another 23%. Willis has just 7%, but that's up 1 percentage point in just the past year—and every point gain in market share is worth about \$230 million in revenue. "It's a very competitive business, but there is vast room for people to succeed and grow," says J. Patrick Gallagher Jr., CEO of No. 4 broker Arthur J. Gallagher & Co., based outside Chicago. "It's all about the brainpower you bring to the fight."

MOTIVATIONAL SPEECHES

PLUMERI HAS a simple strategy for winning market share. First, he'll keep making acquisitions and taking stakes in other firms on top of the more than 20 deals he has done so far. He has the money to do it because Willis' cash flow could top \$350 million this year and \$575 next year, according to Prudential Equity Group LLC analyst Jay H. Gelb. The next step—

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revving up the sales force—is Plumeri's forte. At Primerica he was famous for his boisterous, motivational speeches to his sales crew. His workforce of 150,000 boosted earnings from \$180 million in 1995 to \$550 million in 2000, when he retired. "I love people to say, 'He made me do things I never thought I could do,'" Plumeri says.

Most important, he tore up Willis' organizational chart and assigned each broker to a company rather than to a product to knit closer relationships with customers. That persuaded consumer-products company Alberto-Culver Co. to switch its business from Aon to Willis. "It's more productive to deal with one person" rather than a different broker for each kind of policy, says Gary P. Schmidt, Alberto-Culver's general counsel.

By some measures, Willis already outperforms its rivals (chart, page 106). Last year, the company's revenues grew 20%, to \$2.1 billion, and second-quarter results showed the 18th consecutive quarter of growth in operating earnings. Willis' stock price has soared 118% since KKR took the firm public in June, 2001, turning the firm's \$305 million investment into a \$2.6 billion bonanza. KKR still owns a 5.5% stake and has two board seats. "KKR and Joe revitalized the company," says Gallant. "Brokerage is a sales business; you need that kind of energy."

Enthusiasm alone, however, won't help Willis when the cyclical insurance market—which has enjoyed four years of rising premiums—begins to soften, as many analysts predict. That will eat into earnings, but Plumeri plans to offset that with more fee-based advisory work.

Plumeri, who calls himself "nobody's idea of a typical CEO," says his peers often regret not having enough fun or taking risks. His own lament is not "building monuments to the things I believe in." So he commissioned a statue of his father, a businessman who in 1994 returned minor-league baseball to New Jersey's capital after 44 years. It sits in front of the 6,400-seat Samuel J. Plumeri Sr. Field. Plumeri's Jr.'s regrets, it seems, are too few to mention. ■

By Mara Der Hovanesian in New York

'You Cannot Legislate Honesty'

Fund manager Robert Olstein says the SEC regulators have overstepped the mark

ROBERT OLSTEIN, WHO RUNS the \$1.9 billion Olstein Financial Alert Fund, calls himself an "anti-Establishment" guy. He's known for poring through financial statements, looking for accounting abuses, and taking management to task. Now, Olstein is turning his sights on mutual-fund regulators, arguing that they've gone too far in their crackdown. Another batch of

regulations take effect Oct. 5, a little more than a year after the fund scandals broke. He aired his concerns in an interview with *BusinessWeek's* Karyn McCormack.

What's your basic beef with the new rules?

The SEC and the critics of the industry, who are trying to stamp out criminality and poor ethics, put in new regulations that are anti-shareholder. For instance, they're asking me to resign as chairman [of my fund company]. Not that the chairman is anything other than a figurehead, but it's sending the wrong message to shareholders. There has been a very profitable relationship between mutual funds and individual shareholders.

How do the new rules affect you and your shareholders?

I spend half my day now dealing with regulatory issues. Also, our costs have gone up over \$1 million. The rules are adding insignificant costs to the giant firms, and adding significant costs to the smaller and midsize funds, like mine. These high costs will keep entrepreneurs out of the business.

What's your problem with adding more independent directors?

We have four independent and three affiliated directors. Only independents can



OLSTEIN The new rules are "anti-shareholder"

serve on the audit committee. Only independent directors can vote on whether to rehire me. So having to add independent directors accomplishes nothing.

The U.S. Chamber of Commerce has said it will sue the SEC over the new independent-director rule.

They should. The SEC overstepped its bounds. I don't think it should be telling people who should

be chairman.

Aren't regulators just trying to prevent conflicts of interest?

You cannot legislate honesty and integrity. You punish, disgorge fees, you fine, and the SEC did a good job on that. [New York Attorney General Eliot] Spitzer did a good job on uncovering the issues, but then he went too far. He started telling funds what they should charge. They want us to lower fees, yet they're increasing our costs! Sure, there were some cockroaches in the sink—you don't blow up the whole building.

So the SEC is going too far?

I'm not for anyone behaving criminally or unethically. But there are 1,000 funds that have returned 10% or more between 1998 and 2003 despite a bear market. Does that sound like an industry that doesn't work? I don't think so. ■

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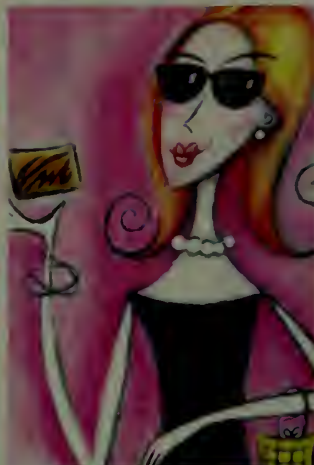
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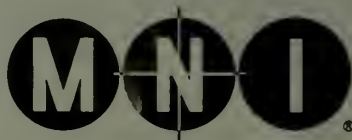
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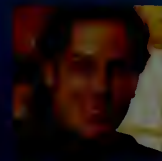
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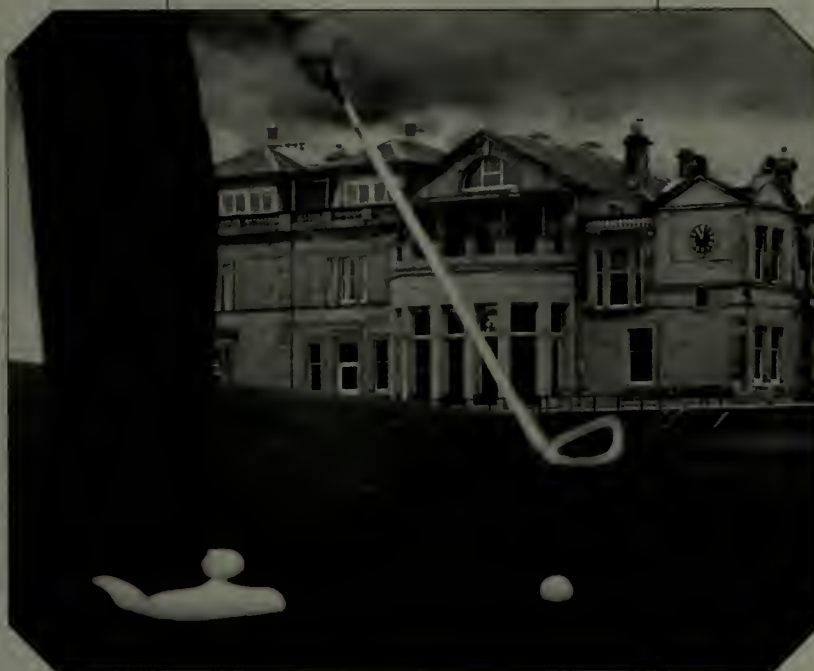
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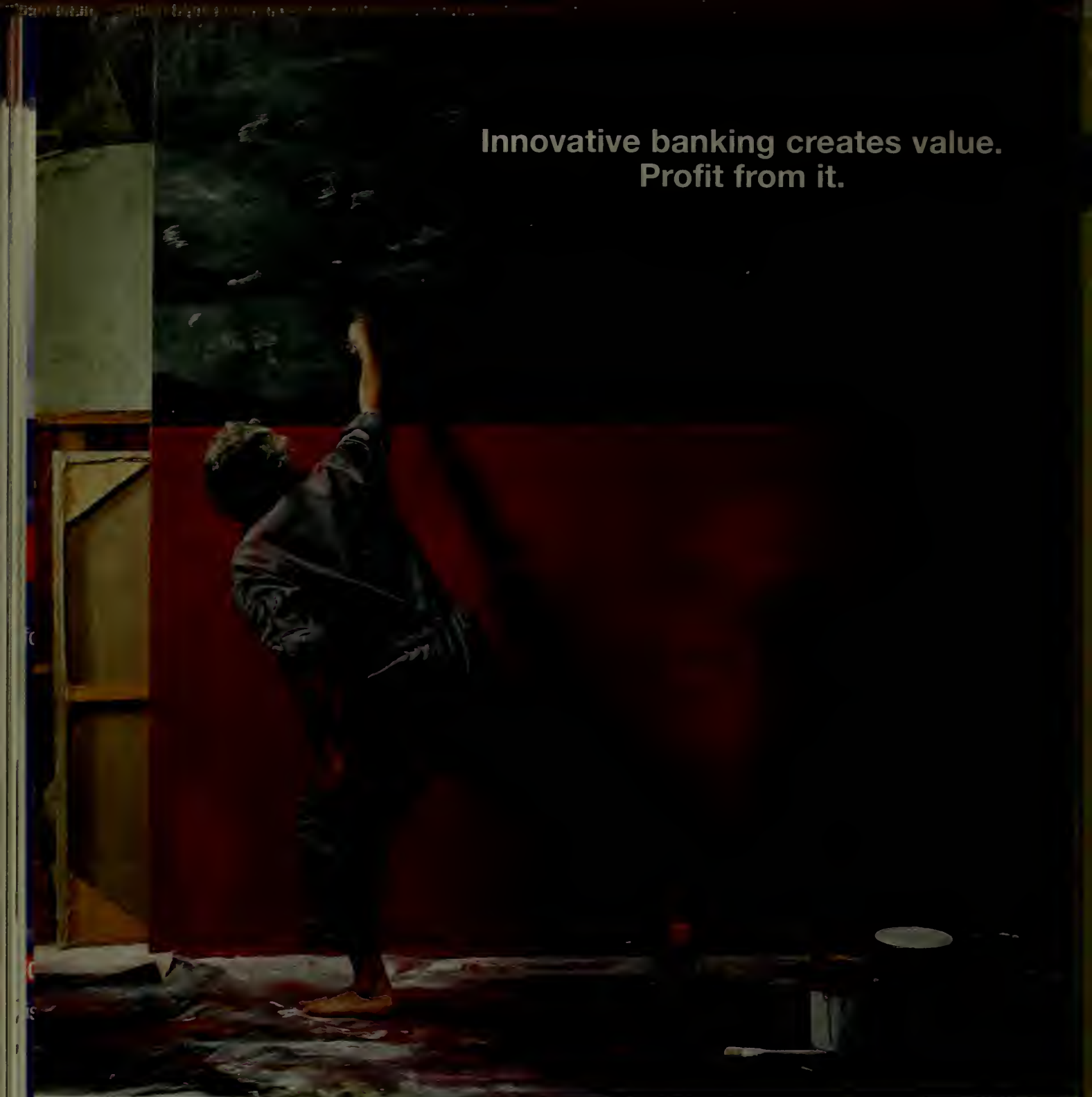


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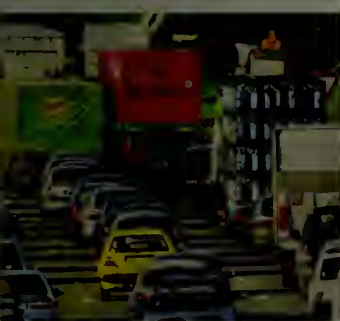
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INNOVATIONS

Cargo catamarans and SARS drug

»» A high-speed cargo catamaran could go a long way toward reducing truck congestion on Europe's roads. Under development by a consortium of 14 European partners, including British naval architects IMAA, the vessel is part of a European Union program to research environmentally friendly transport. It's slated to carry the equivalent of 45 truckloads of goods. Thanks to air cushions like the ones found on hovercraft, the vessel will be able to cruise on rivers and seas at 25 mph—twice the speed of current freighters. The craft is scheduled to be afloat on the Danube by 2006.



»» Belgian researchers may have found a treatment for SARS that is both inexpensive and widely available. Virologists from the Katholieke Universiteit Leuven found that the common antimalarial drug chloroquine fights the infection in cell cultures. The research team is now prepared to begin testing on animals. "We are also looking to see if any derivations of chloroquine are more effective than the drug itself," says Marc Van Ranst, a professor at the university. Currently no satisfactory treatment for SARS exists.

—Rachel Tiplady



SOLAR ENERGY FROM BERKELEY TO BAVARIA, A BLUE-RIBBON PANEL

NEXT MONTH, the world's biggest solar-cell operation—Bavarian Solarpark, near Munich—will start cranking out juice. By yearend, it will be pumping 10 megawatts into the local grid. PowerLight in Berkeley, Calif., is supplying the park's 57,600 solar panels, and Siemens is handling grid connections.

CEO Thomas Dinwoodie says PowerLight won the lion's share of the \$60

million project because of its PowerTracker panels. Unlike most solar cells, they swivel to follow the sun. "That increases energy production in the morning and late afternoon," boosting daily flow by as much as 30%, Dinwoodie says. Thanks to a far-sighted state program to stimulate solar power, Germany is the world's No.2 market for photovoltaic technology, topped only by Japan.

—Otis Port

OPHTHALMOLOGY THREE BLIND MICE—BEFORE STEM CELLS

STEM CELLS, the precursors to all the body's tissue, may be able to halt certain types of blindness. Dr. Martin Friedlander of the Scripps Research Institute in La Jolla, Calif., says his team saved the vision of mice suffering from retinitis pigmentosa, a disease that destroys the retina, by injecting adult stem cells derived from bone marrow into the back of their eyes. Working on mice genetically engineered to develop the

disease, the team found that the stem cells, injected a few weeks after birth, kept the retina from degenerating. The results were reported in *The Journal of Clinical Investigation*.

Retinitis pigmentosa, which causes blindness in one in every 3,500 people, has no cure. Triggered by gene mutations, it prevents proper formation of the retina at birth. Friedlander theorizes that the therapy may be effective since stem cells are loaded with heat shock proteins, used by the body to protect cells from premature death. He hopes to test the technique in humans in three or four years.

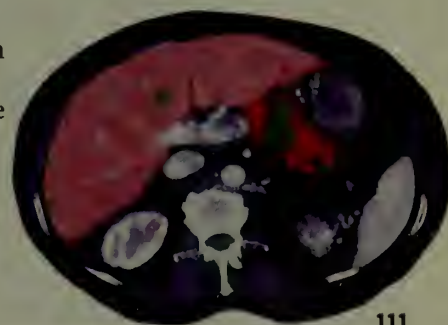
CANCER WATCH GIVING A SUGAR SHOCK TO CANCER CELLS

ALL CELLS need oxygen and glucose. But cancer cells need a lot more glucose to grow rapidly. Threshold Pharmaceuticals in South San Francisco has come up with a drug that exploits cancer cells' sugar jones to make chemotherapy more effective.

The drug, glufosfamide, consists of a traditional chemotherapy treatment, ifosfamide, with a glucose molecule attached. Normal cells take in little of the drug, but cancer cells, greedy for glucose, suck in large amounts and die. In Phase 2 studies of glufosfamide used against advanced pancreatic cancer, patients survived a median of 5.6 months, two months longer than the average for late-stage disease. Threshold President George Tidmarsh says 9% of patients in the trial are still alive after two years. Glufosfamide's side effects included nausea, vomiting, and kidney impairment, which are common to chemotherapy.

It may also prove useful for lymphomas and breast and colon cancer, Tidmarsh says. Threshold is recruiting pancreatic-cancer patients for a Phase 3 trial, and results are expected in a year. —Amy Tsao

GREEDY FOR SWEETS Cancer (green) in the liver (left) and pancreas (right)



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Good-bye Grainy Cell Pics

Wireless carriers are starting to offer cell phones equipped with high-resolution, one-megapixel cameras. **BY LARRY ARMSTRONG**

THEY HAPPEN A LOT—those Kodak moments you have to pass up because you've left your camera at home. But chances are you didn't forget your cell phone: It's one gadget that's always with you, tucked away in a pocket or purse. These days, with more cell phones sporting built-in digital cameras, you no longer have an excuse to miss a great shot. That's especially true now that U.S. wireless carriers have started offering phones with one-megapixel cameras. Old hat in much of the world, these phones have more than three times the picture resolution of older models, and they can produce high-quality prints rather than grainy, washed-

out images that are suitable only for e-mail.

Last month I got my hands on five one-megapixel camera phones that are on the market now or will be shortly (table)—from Audiovox, Motorola, Nokia, Samsung, and Sony Ericsson. To get an idea of picture quality, I took pretty much the same photos on each and made 4 x 6 prints at a Kodak kiosk in a CVS drugstore in Los Angeles. Just for comparison, I also shot with a couple of phones that use so-called VGA cameras, which capture only 300,000 pixels instead of 1 million.

Generally, I found cell-phone cameras not as versatile (or as complicated) as



On Hand For **Candid** Shots

These gadgets let you capture the moment—and share it.



AUDIOVOX

CDM-8920

PRICE \$300, from Sprint
(\$120 with contract)

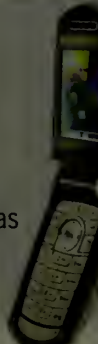
It's the first megapixel camera phone to market, but picture quality is poor. No Bluetooth or infrared.

MOTOROLA

V710

PRICE \$320, from Verizon
(\$250 with contract)

Picture quality is marginal for this 1.2-megapixel camera. Has Bluetooth for headsets, but it won't transmit images.



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of TIPS

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Less of an ordeal

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jerseys and caps

130 Barker: Revisiting
Krispy Kreme



good digital cameras. It can also be more difficult to get your images out of the phone and into a place where you can store or print them. But many of the megapixel prints I made were photo-album quality, with the best ones from the Nokia phone, closely followed by those shot on the Sony Ericsson model.

PHONE TRICKS

THE MOST SURPRISING thing I discovered was that I could get acceptable prints from the VGA phones, as long as I printed them a little smaller. At dotPhoto.com, you can order 4x3 "cell prints" for 11¢

each. The company printed my first batch incorrectly as vertical prints instead of horizontal. When contacted, it replaced the order overnight.

Camera phones let you do a lot more than just make prints. You can link photos of your friends to their phone numbers so their picture pops up on the screen when they call you. You can personalize your phone with your own photos as wallpaper. Or by subscribing to a mobile photo service (\$2 to \$4 a month) such as dotPhoto's Pictavision, Kodak Mobile, or Snapfish Mobile you can transfer pictures taken on your

digital camera to your phone, to show off snapshots you now carry in your wallet.

But the whole point of boosting the picture quality in camera phones is to get printable snapshots. So you don't repeat my mistakes, here are some tips.

Get close. These cameras tend to lose the details in vast panoramic shots but are great for close-ups, where the subject fills the entire frame.

Turn on the lights. Camera phones work best outdoors in bright light. Indoors, make sure there's enough light to illuminate your subject. If your phone has a flash, use it, but it's not effective



NOKIA 7610

PRICE \$400, from Cingular in October

Comes with Bluetooth and a memory card, and its picture quality is **the best** of this group.



SAMSUNG MM-A700

PRICE \$400, from Sprint (\$220 with contract)

The lens can rotate 180 degrees for self-portraits. No Bluetooth, infrared, or memory card, but the picture quality is **O.K.**

SONY ERICSSON S700

PRICE \$500, from soniericsson.com in October

Camera swivels open to use as a phone. Picture quality is **good**, and has Bluetooth and infrared for file transfers.



Personal Business

more than a couple of feet away. **Use the white balance settings.** Different types of light can alter the colors in your snapshot, making it too red or too green. You can adjust newer camera phones for sunny or cloudy days, and for fluorescent or incandescent lights.

Keep still. Your natural inclination is to hold your phone in one hand. You can keep it steadier if you use two. Or try stabilizing your hand by resting it on something while you push the shutter button.

A word about wireless costs. If you never send a picture from your phone,

you'll incur no extra charges. Many one-megapixel phones, such as the ones I used from Motorola, Nokia, and Sony Ericsson, have slots for removable memory cards, so you can transfer your snapshots to your computer, printer, or a retail print kiosk. Some phones have a built-in infrared or Bluetooth link so you can beam them to a similarly equipped device.

Otherwise, you'll have to e-mail the images to yourself, and the wireless carriers will bill you. The best bet for confirmed shutterbugs is Sprint, which

charges \$15 a month for unlimited picture mail. T-Mobile has a good deal for casual photographers: \$2.99 per month for the first 20 pictures and 10¢ apiece after that. (Cingular has a similar plan but charges 25¢ for additional shots. Other carriers are more expensive ranging from 25¢ (Verizon) to 40¢ (AT&T) each.

Don't get rid of your digital camera just yet. But play around with the camera in your cell phone. If you're like me, you'll find it's even more fun than a digital camera—and a lot more convenient. ■

Mutual Funds

Where to Shop at Vanguard

Its actively managed funds still have a big cost advantage. **BY LAUREN YOUNG**

FIDELITY INVESTMENTS fired a salvo right at indexing powerhouse Vanguard Group when the mutual fund giant slashed the expense ratios on five stock index mutual funds on Aug. 31. For now, at least, that effectively eliminated Vanguard's long-held edge on the cost of index investing.

So what does this mean for fund investors? That depends on how much you're putting into index portfolios. Vanguard sets just \$3,000 minimum investments for its index funds (\$1,000 for individual retirement accounts); Fidelity requires a \$10,000 minimum. Vanguard also offers more index fund flavors, with 48 portfolios that cover every corner of the stock and bond markets. Investors with \$10,000 or more will do better at Fidelity: Expenses run \$10 for every \$10,000 invested on Spartan 500, Spartan Total Market, Spartan Extended Market, Spartan International, and Spartan U.S. Equity index funds. Vanguard charges \$18 to \$36 for similar funds.

OUT OF REACH

STILL, THERE'S MORE to Vanguard than just index funds. Its actively managed funds stand up well to Fidelity's, performance-wise—and, of course, beat them hands down on expenses. The typi-

cal Vanguard actively managed stock fund has an expense ratio of just 0.31%, which is less than half that of the average actively managed Fidelity fund, according to Morningstar.

The problem—for prospective Vanguard investors—is that some of its best actively managed funds are out of reach. Vanguard International Explorer and

make it hard for newcomers to invest.

Fortunately, Vanguard has some worthy portfolios still open to investors for a \$3,000 minimum. Daniel Wiener, editor of the *Independent Adviser for Vanguard Investors*, recommends Vanguard Explorer, Growth & Income, Windsor II, and U.S. Value (table). Wiener suggests using Windsor II as a core holding because the \$30 billion fund focuses on large-cap value stocks.

More aggressive investors might consider Strategic Equity, a quantitatively managed fund that Vanguard runs in-house. The fund's computer models do a stellar job of picking stocks: The \$3 billion portfolio has beaten most of its peers in the past three and five years.

If you are looking for a back door into the

Investors Welcome

Some of the best actively managed Vanguard funds are closed to new investors—or have high minimums of \$10,000 and even \$25,000. Here are five that are still open and require just a \$3,000 investment.

FUND NAME/TICKER	INVESTMENT STYLE	EXPENSE RATIO	3-YR. TOTAL RETURN*
Explorer (VEXPX)	Small-cap Growth	0.72	7.20%
Growth & Income (VQNPX)	Large-cap Blend	0.46	3.63
Strategic Equity (VSEQX)	Mid-cap Blend	0.50	11.57
U.S. Value (VUVLX)	Large-cap Value	0.63	6.85
Windsor II (VWNFX)	Large-cap Value	0.43	5.48

* Appreciation plus reinvestment of dividends and capital gains, before taxes. Three years ending Sept. 13, 2004.

Data: Morningstar Inc.

Vanguard Primecap, for instance, are closed to new investors. To buy into Vanguard Health Care, you need to put in at least \$25,000. "We want to make sure that a fund keeps its character over time," says Jeffrey Molitor, Vanguard's head of portfolio review. Such moves protect existing shareholders' interests but

Primecap or Capital Opportunity funds. Primecap Management—which runs those Vanguard funds—is expected to roll out three funds under its own label. Be prepared to pay higher expenses, though, for Primecap's own offerings. No one has yet been able to undersell Vanguard on actively managed funds. ■

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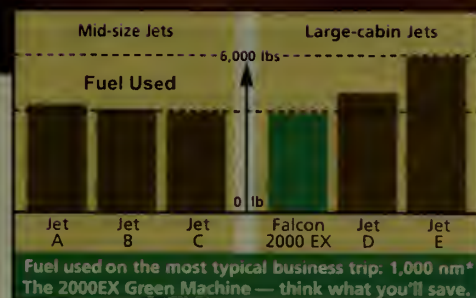


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*Source: Business & Commercial Aviation, May 2004

Why TIPS Are Still a Buy

Despite a recent slide, they provide a sound inflation hedge. **BY CHRISTOPHER FARRELL**

ECONOMISTS ARE UNIFORM in praising Treasury Inflation-Protected Securities (TIPS), as one of the best safeguards against an overall rise in prices. Yet toward the end of August, with the annualized rise in the consumer price index (CPI) running around 3%, oil flirting with \$50 a barrel, and Wall Street sounding repeated warnings about inflation pressures, the value of TIPS declined. Some inflation hedge, right?

Don't be misled by short-term fluctuations in the market. TIPS will, indeed, behave as they were intended to—if you hold them until maturity. You're assured of a real, after-inflation return because the bond's principal is adjusted to reflect changes in the CPI. The inflation adjustment occurs semi-annually but uses the data available closest to the adjustment date. The current real fixed-interest rates are just 1.8% on a 10-year and 2.2% on a 30-year issue.

In the meantime, TIPS prices often bounce around as inflation expectations

rise and fall—and right now they're waning. Demand from professional bond traders is down, too. Real yields would have to go much higher—say, near 3%—to attract their interest, says Bulent Baygun, head of fixed-income strategy at Barclays Capital. Even so, TIPS are having a good year, sporting a total return of 5.2% compared with 3.1% for the Lehman Brothers Aggregate Bond index and 2.1% for the Standard & Poor's 500-stock index.

NOT SO VOLATILE

IF YOU CAN GET PAST the short-term price wariness, TIPS are a compelling investment. For one thing, inflation-indexed bonds are increasingly perceived as a separate asset class because they don't follow the movement of other types of investments such as stocks and conventional bonds, says David Darst, chief investment strategist for Morgan Stanley's Individual Investor Group. In other words, TIPS add diversification to your portfolio. Over the past five years, they've had a negative correlation with the S&P 500 and the Lehman U.S. Aggregate Bond index. They're also about a third less volatile than traditional Treasury bonds of similar maturity. "TIPS certainly belong in most folks' retirement portfolios," says William Bernstein, author of the *Intelligent Asset Allocator*. "The return is not bad, and they provide a decent inflation hedge."

The inflation-linked market is also becoming increasingly liquid. The U.S. government started selling TIPS in 1997, and the market now exceeds \$220 billion, according to Bridgewater Associ-

ates, an investment research firm. TIPS of various maturities are expected to make up about 16% of the Treasury market (excluding Treasury bills) by 2005, says Barclays' Baygun.

There are new entries to the inflation-indexed market: some \$9 billion in corporate inflation-linked bonds. Most issuers are blue-chip borrowers such as Fannie Mae, Sallie Mae, and Morgan Stanley. The corporate bonds are more sensitive than TIPS to short-term swings in the inflation rate since they pay interest monthly, based on the CPI for the trailing 12 months. Still, they aren't generating much enthusiasm from investors, mainly because they're paying on average a mere 0.5 of a percentage point more than comparable TIPS. "There haven't been many issuers, and the small amount of extra yield hasn't typically made up for the credit risk and the state income tax exemption on TIPS," says Ross Levin, president of Accredited Investors, a financial planning firm in Minneapolis.

In the end, inflation-indexed securities backed by the U.S. government still rank among the safest long-term investments. So don't be fooled—or worried—by price fluctuations. If there is even a remote chance that inflation will stir, you should consider TIPS as a core holding. ■



THE UPS AND DOWNS OF INFLATION BONDS

Lehman Brothers' U.S. Treasury Inflation Notes Index



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BELL After her laparoscopic hysterectomy

Women's Surgery: Less of an Ordeal

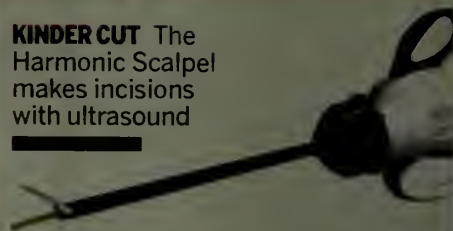
Laparoscopy can cut recovery times, but you may have to ask for it. **BY CAROL MARIE CROPPER**

IF YOU NEED YOUR GALLBLADDER removed, most likely it will be done laparoscopically—through tiny incisions using a miniature video camera and special surgical instruments. Same is true for a gastric bypass if you want to lose weight, as well as other operations that once required slicing open the abdomen. Now, this minimally invasive technique is transforming women's surgery, as it moves from simple procedures such as tubal ligations to hysterectomies and re-

moval of fibroid tumors. But, as is often the case in medicine, to benefit from this advance you often have to know enough to ask for it.

Since many gynecologists are not trained to perform the more difficult laparoscopic operations, they are apt to recommend traditional open-abdominal surgeries, says Dr. Franklin Loffer, medical director at the American Association of Gynecologic Laparoscopists. Only about 10% of the approximately 650,000 hysterectomies performed each year are done la-

KINDER CUT The Harmonic Scalpel makes incisions with ultrasound



paroscopically. Perhaps 5% to 10% of all myomectomies to remove benign uterine fibroids are handled this way. On the other hand, 85% of all gallbladders are taken out laparoscopically, and, in women, laparoscopy is used in most surgeries to excise ovarian cysts or endometrial tissue that grows outside the uterus.

Not all patients are good candidates for laparoscopic surgery. Anyone who cannot tolerate general anesthesia may have to opt for open surgery, since doctors cannot use an epidural to numb just the lower body. Laparoscopy is generally performed while the patient is completely under. Ovarian cancer patients usually should have an open operation to let the surgeon evaluate the cancer and remove adjoining tissue. And many surgeons will turn away a woman with a large uterus or very big or numerous fibroids.

SAVING MONEY

FOR OTHERS, HOWEVER, a laparoscopic hysterectomy can mean the difference between three or four half-inch or smaller incisions and a 6-to-12-inch gash in the belly. Recovery time is one to three weeks vs. up to six weeks for an abdominal hysterectomy. Many patients don't even need an overnight hospital stay. That can make the overall cost of a laparoscopic hysterectomy comparable to that of an open procedure, which typically runs around \$6,000 and requires a two-to-three-night hospital stay. Also, several studies have shown that the less-invasive surgery is not so likely to result in internal adhesions that can bind organs and create painful bowel obstructions.

Dr. Hallie Bell, a neurologist, was concerned about recovery time and adhesions when she needed a hysterectomy last year. Then living in Destin, Fla., she searched until she found an Atlanta surgeon willing to do it laparoscopically. He was Dr. Ceana Nezhat, one of three brothers who are leaders in the field.

Using an experienced surgeon is important. A British study published earlier this year in the online edition of *BMJ* (formerly the *British Medical Journal*) reported more frequent complications such as hemorrhage and blood clots after laparoscopic surgery. Even proponents say such complications can be a problem in inexpe-



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rienced hands and that if a novice is doing the procedure, the patient will probably spend more time on the operating table than the typical one to four hours.

A patient should ask not just how many—but what type—of laparoscopic surgeries the doctor has performed, advises Dr. Elena Yanushpolsky, director of reproductive surgery at Brigham & Women's Hospital, the teaching hospital for Harvard Medical School. A study published this May in the *Journal of the American Association of Gynecologic Laparoscopists* reported a learning curve of about 80 surgeries for one type of laparoscopically assisted hysterectomy.

Many patients don't even stay in the hospital overnight

Meanwhile, there are other options to avoid the knife. Fibroids can be killed by injecting

polyvinyl particles to block their blood supply. The procedure, called uterine artery embolization (UAE), is not recommended for women who may want to become pregnant or whose fibroids hang by only a stalk.

GENTLY, GENTLY

A UTERUS CAN be removed vaginally—although laparoscopy is sometimes used to assist in such surgeries. On a recent morning, Nezhat performed a hysterectomy on a 49-year-old woman in an operating room at Atlanta's Northside Hospital. He made three small incisions and inserted laparoscopic tools to cut loose her uterus. He then took it out through her vagina. The laparoscopic part of the procedure allowed him to see what he was doing and to cut away adhesions and endometrial tissue. The important thing for patients is to study the alternatives, says Nezhat. "That way, you have less chance of regret."

Bell is glad she did her homework. When her surgery was over, Nezhat told her he found five adhesions tying her intestines to her abdominal wall—legacies from surgery for an old automobile accident, as well as a C-section. Had a surgeon performed an open hysterectomy, he might have cut through her bowel—a serious complication that would have meant, at best, a lengthy hospital stay. Instead, a month later, she started a new job in Mississippi. ■

One Hank Aaron Shirt, Please

Retro duds from teams of long ago are hitting home runs at the sales counter. **BY MARK HYMAN**

WHEN SCOTT SIMON slides behind the microphone at the National Public Radio studio in Washington, he is sometimes dressed in baseball garb. But his warm-up jacket sports the logo of the Chicago American Giants, not the White Sox or the Cubs, and his jersey says Montreal Royals, not Montreal Expos. The minor-league Royals were Jackie Robinson's team before his momentous promotion to the majors in 1947. The American Giants of the old Negro Leagues played its last game in the 1950s.

For fans of baseball history, the ultimate cool is a jersey, cap, or jacket made to the exact specifications of a decades-old, or even century-old, original—with heavy flannel, hand stitching, and felt patches. The best at reproducing ballpark styles of yesteryear are Coopers-

town Ball Cap, Stall & Dean, and Mitchell & Ness Nostalgia, manufacturers that have carved out niches within niches in the quirky throwback biz.

Cooperstown Ball Cap Co.'s line is the most focused. The tiny company manufactures just baseball caps from a large shed on a country road near Cooperstown, N.Y., home of the National Baseball Hall of Fame. For \$44, it duplicates virtually any cap worn by any team, including forgotten ones such as



BYGONES A
1919 Chicago American Giants jersey and one from the '82 Knicks

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the 1904 Grand Forks (N.D.) Forkers and the 1912 Battle Creek (Mich.) Crickets. All told, the company makes more than 2,000 carefully researched wool models, each on display at its Web site, ballcap.com.

Stall & Dean sells baseball items (mostly jerseys and jackets of Negro League and minor-league teams), as well as offbeat throwbacks for football, basketball, hockey, and even the Roller Derby (stallanddean.com). Mitchell & Ness Nostalgia Co. specializes in jerseys worn by star players in their star seasons. The company's top seller last year: a replica Atlanta Braves shirt worn by home-run king Hank Aaron back in the days when he toppled Babe Ruth's record in 1974 (mitchellandness.com).

The customers of the vintage sports gear companies are a varied lot: baseball history buffs, dealers who get players to autograph jerseys or caps and then sell them in sports memorabilia stores and online, teens making a fashion statement

by copying what performers are wearing on music videos, and celebs yearning for a new look. William Arlt, a former vintage-clothing dealer who started Coopers-town Ball Cap in the mid-1980s, filled an order for about two dozen caps from comic George Carlin, who wanted team caps emblazoned with the initials G or C. Arlt also has supplied caps for movies, including a few hundred emblazoned with a red R in a white circle for the Rockford Peaches, the team portrayed in the 1992 film

Teens buy gear to make a fashion statement

1951 A cap from the Brooklyn Dodgers



KEEPING IT REAL
In Seattle, Cohen is a stickler for authenticity

A League of Their Own
A worker for Arlt dropped notes into the leather bands of caps worn by Madonna, one of the stars, but

says Arlt, he never heard back.

Like Arlt, Stall & Dean President Jerry Cohen is a stickler for keeping it real. Cohen, who launched his company after becoming fascinated with Negro League history, refused to sell any merchandise that was not an exact replica. "I was selling wool jerseys, wool jackets, wool hats. That was it. You couldn't buy a T-shirt or anything else I considered 'made up,'" says Cohen, surrounded by a 1950 Mexico City Diablos Rojos baseball jacket (\$400) and a red-and-white 1972 Soviet Union Olympic team hockey sweater (\$225) at Stall & Dean's retail store in downtown Seattle. Eventually, Cohen relented, partly to woo customers scared away by his prices, such as \$235 for a 1924 Atlantic City Bacharach Giant wool baseball jersey. "We added T-shirts [with logos of vintage teams] for people who couldn't afford the \$300 jackets," Cohen says. A shirt for the Des Moines Undertakers costs \$29.

SHELLING OUT

DEMAND FOR SOME of the replica jerseys is steady. Baseball shirts of the San Francisco Seals (Pacific Coast League) and New York Black Yankees (Negro Leagues) are popular, says Cohen. So is the colorful game jersey of the Havana Sugar Kings, a pre-Castro minor-league club.

Price is no obstacle for Peter Capolino's Mitchell & Ness customers. Their willingness to pay \$250 for 1985-86 Boston Celtic jerseys and \$350 for a 1977-78 replica Pittsburgh Penguin hockey shirt has pumped up revenues at Capolino's Philadelphia-based, family-owned business from a little over \$4 million in 2001 to \$35 million last year.

If items such as those don't max out the credit card, Capolino might also interest you in a 1944 St. Louis Browns warmup jacket, which goes for \$400. Mitchell & Ness sold 76 of them last year. "A 75-year-old man will see the jacket and remember Bill Veeck owned the team and a midget once came to bat for them," says Capolino. "A 17-year-old will see a fall color fashion, brown, orange, and butterscotch, and think 'Way cool.'" Either way, it's the next best thing to owning the original. ■

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PUT A PERSONAL STAMP ON IT



YOU NO LONGER have to be dead to get your mug on a postage stamp. **Stamps.com** will print almost any photograph, along with official

postage, on an adhesive sticker that's good for U.S. mail. Just don't try to submit a picture of Adolf Hitler or a nude celebrity: The company refuses to print any images that it deems inappropriate. The PhotoStamps come in sheets of 20, and they're not cheap: Each stamp costs 30¢ to 50¢ more than the face value of the postage, depending on how large a quantity you order. Still, it's an easy way to personalize mail for special events—such as wedding invitations, graduation notices, or birth announcements.

MUTUAL FUNDS

LEARNING IF YOUR MONEY IS UP TO NO GOOD

WANT TO KNOW if your mutual fund portfolio is affecting the environment? A new site, www.cooking-yournestegg.org, reveals which of the 24 largest U.S. equity funds own companies that may be contributing to global warming. The site, sponsored by the **Civil Society Institute**, a progressive think tank in Newton Centre, Mass., also shows fund holdings in companies that have taken positive actions to deal with climate change. Vanguard 500 Index portfolio, for example, has a stake in **ExxonMobil**, which the site says has a "reputation for resisting the cautions raised by environmentalists." On the plus side, it owns **Johnson & Johnson**, which cut energy use by 23% in 2000.



DINING

Indian Fusion

ONCE UPON A TIME, fusion restaurants meant a blend of French and Chinese cuisines. Today it could be almost anything, from Wolfgang Puck's still-crowded **Chinois on Main** in Santa Monica, Calif., to a chain of Hawaiian eateries called **Roy's**. So what's next? Indian and you name it.

As the number of South Asians in the U.S. rises and Americans tire of yesterday's food craze, restaurants that combine Indian spices with dishes from other lands are as hot as curry. To see what the buzz is all about, check out Chicago's **Vermilion**, a pairing of Indian and Latin American cuisines. The chef's favorite: barbecued ribs rubbed with garam masala, braised in Coke or Pepsi, brushed with tamarind paste, and served with yucca shoestring fries and sweet-corn salsa.

New York has a couple of spots in this category, too: **Taj** (Indian/American) and **Raga** (Indian/French). Elsewhere there's **Mantra** in Boston, **Tallula** in San Francisco (both Indian/French), and **Masala Wok** in Richardson, Tex. (Indian/Chinese). They don't call America a melting pot for nothing.

—Michael Arndt

INVESTING

WITH THE STOCK MARKET laboring to sustain any gains, investors in dividend-paying companies have something to crow about. In the past 2¾ years, the 376 dividend yielders in the Standard & Poor's 500 have trounced the 124 nonpayers in the total return column. "Investors appear reluctant to sell stocks that will give them another payment within three months. On the other hand, they may be perfectly willing to sell a stock they bought only for its appreciation potential, if that potential hasn't been realized," says *The Outlook* from S&P.

	TOTAL RETURN*	
	YEAR TO DATE	SINCE DEC. 31, 2001
Dividend-paying stocks	6.84%	23.65%
Non-dividend payers	-4.06	8.03
S&P 500	2.47	2.73

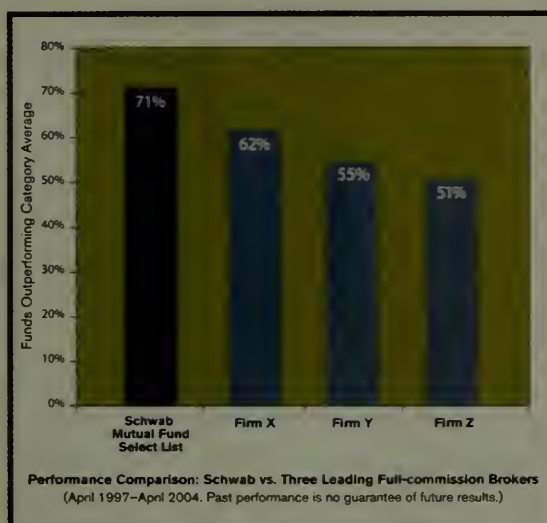
*Appreciation plus reinvestment of dividends through Sept. 13, 2004

Data: Standard & Poor's

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Investment value will fluctuate, and shares, when redeemed, may be worth more or less than original cost.

Schwab receives remuneration from funds participating in the Mutual Fund OneSource for shareholder and other administrative services. Based on aggregated results of a total of 731 fund selections, appearing in nine quarterly Mutual Fund Select Lists beginning with the Q1 1997 list. Performance of each quarterly Select List was measured against its corresponding peer group benchmark over the five-year period following the first month after publication of the respective Select Lists. Category peer groups were constructed as the average performance of all funds that had five-year returns in each Morningstar category existing at the time of each Select List's publication. Annualized returns include reinvestment of fund distributions. The Select List performance includes analysis of transaction fee funds appearing on the Select List during the specified period. As of Q4 2003, transaction fee funds are not included on the Mutual Fund OneSource Select List. Competitor funds average is based on the primary share classes (as identified by Morningstar) of the proprietary and affiliate funds of three leading brokerage firms — Firm X, Merrill Lynch & Co., Inc.; Firm Y, Morgan Stanley & Co., Inc.; and Firm Z, Smith Barney (1,905 total fund observations using the same methodology and over the same nine time periods as the Select List). Fund performance not adjusted for loads. The universe of competitor proprietary and affiliate funds was identified on best efforts basis via information available through Morningstar and may not include all those funds available throughout the period. Schwab will rebate up to \$200 toward exit fees. Exit fees may exceed this amount. Short-term redemption or live broker fees may apply. ©2004 Charles Schwab & Co., Inc. Member SIPC. (0804-10267). ADS30182FUL.



BY ROBERT BARKER

Why Krispy Kreme Is Worth a Bite

Are doughnuts poison? You might think so, from a look at Krispy Kreme Doughnuts' stock chart. Under \$12, the stock's off 77% in 13 months. Yet few on Wall Street see an opportunity. Indeed, the stock is nearly inedible to investors, who fret over the low-carb craze, not to say Krispy Kreme's own many blunders.

Although you might call me the Will Rogers of doughnuts (never met one I didn't like), Krispy Kreme's shares never tempted me. Way too rich. Yet now I'm wondering: Is all the bad news already reflected in the stock? Investors are giving Krispy Kreme a market value of \$750 million, putting it 24th on the list of restaurant stocks, well below even such careworn names as Panera Bread. Are they overreacting?

INDISPUTABLY, THE STOCK presents some glaring risks, starting with the Securities & Exchange Commission's probe into how Krispy Kreme bought back franchise rights in such markets as Dallas. Whether the SEC ultimately will force Krispy Kreme to account for these deals differently is a question mark. Another is future profit growth. Krispy Kreme first said it expected earnings this fiscal year, ending January, of about \$1.17 a share, a 29% gain. In May, it revised that to \$1.05 or so. In July, when Krispy Kreme disclosed the SEC's inquiry, it noted that the agency also was questioning the lower estimate. On Aug. 26, it quit forecasting earnings.

Hardly an alluring outlook. Just the same, these worries may pose less danger to investors than to management's credibility. Take the SEC. Although the agency does not

discuss its probes, Krispy Kreme described the inquiry as informal. Let's say, though, that it turns more serious, and Krispy Kreme ends up restating its books. That might prove humiliating for Chief Executive Scott Livengood. He is not talking now, but in July he declared: "We are confident in our practices." For investors, however, it would hardly spell fresh financial trouble. If Krispy Kreme had to take the



extreme step of writing off all of the \$124 million in reacquired franchise rights that it booked as intangible assets in fiscal 2004, it would post a huge special loss and slash shareholders' equity, to \$4.98 a share from \$6.94. But even in this drastic—and highly unlikely—event, cash flow would be untouched: The dough Krispy Kreme spent to buy those franchise rights is long gone. It's history.

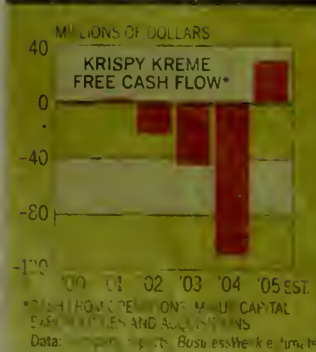
SWEET Krispy Kreme is focusing on wider margins

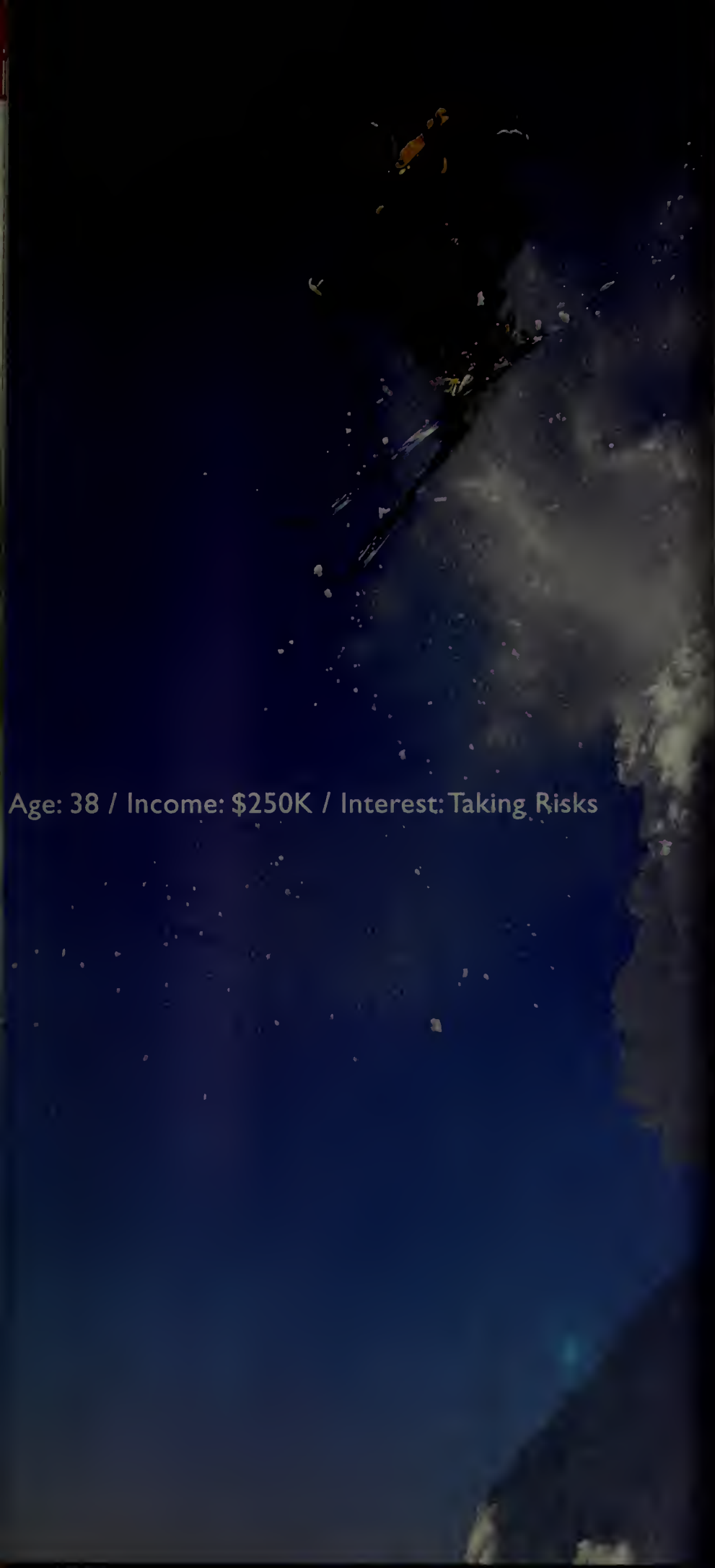
A bigger imponderable to me is Krispy Kreme's future profits. In August, the company told analysts it would slow its expansion, which took it to 427 stores now from 218 in February, 2002. One aim of the more tepid growth plan is to focus on widening margins at newer stores. Another is to use capital more sparingly via more modest stores, which rely on smaller machines to produce fresh, hot doughnuts. What might these moves produce? Better cash returns. In this year's first half, Krispy Kreme posted operating cash flow of \$50 million, up from \$38 million the previous year. Suppose the company can match fiscal 2004's full-year cash flow of \$95.6 million. Then, because Krispy Kreme now is spending less on expansion, it could wind up with substantial free cash flow—that is, cash after capital spending and acquisitions—for the first time since going public (chart).

Don't expect Krispy Kreme to regain its status as a cult stock. Yet the shares have room to rise. The Street's bearish consensus on earnings is 69¢ a share this fiscal year and 81¢ in 2006. That means the stock's price-earnings ratio is less than 0.9 times its expected growth rate. The average comparable figure for other restaurant stocks is 1.3 times. With apologies to Will Rogers, who once quipped that if a stock "don't go up, don't buy it," Krispy Kreme is a buy. ■

E-mail: rb@businessweek.com

RISEING DOUGH?





Age: 38 / Income: \$250K / Interest: Taking Risks

BROKER

34

32

We call it Captivate time, those weekday hours from 7 am to 7 pm, when our upscale audience is out of the reach of most other media. A traditional media plan may miss these desirable customers. But they can't get away from us. Whether they've been out and about or up on the slopes, come Monday morning, they're back riding elevators with us.



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Personal Business Inside Wall Street



BY GENE G. MARCIAL

CELL-PHONE TOWERS: A BUYOUT MAY LOOM FOR SPECTRASITE.

ARE CENTRAL EUROPEAN'S SPIRITS POISED TO RISE IN THE EU?

LAVISH PROMOTION BY DEUTSCHE POST IS GIVING ABX AIR A LIFT.

SpectraSite Stands Tall

AS CELL PHONES HAVE SPREAD, so have wireless towers—used as antennas by carriers such as Nextel and Sprint PCS. The No. 3 player is SpectraSite (SSI), whose stock is up from 33 in March, to 45. It owns and leases about 7,500 towers. “SpectraSite’s strong cash flow and revenue growth—and modest debt—are propelling the stock,” says Kris Tomasovic Nelson of Forstmann-Leff Associates, which owns shares. These factors also fuel takeover rumors, she adds. A possible buyer, say some pros: No. 2 Crown Castle International, with more than 10,600 sites in the U.S. and a market cap of \$3.3 billion. SpectraSite’s market cap is \$2.2 billion. Crown sold its British arm for \$2 billion and could well buy SpectraSite and push it ahead of No. 1 American Tower, which has 12,440 U.S. sites. Even with no buyout, SpectraSite is worth 60, says Nelson, based on 20 times estimated 2005 free-cash flow (operating profits after capital and net interest expenses) of \$2.90 a share. Her 2004 forecast is \$2.25. David Barden of Banc of America Securities says growth in cell usage and subscribers is firing up the business. “SpectraSite is the best-positioned and most attractively valued stock” in the group, says Barden, who sees it earning 65¢ in 2004 and \$1.35 in 2005, vs. 5¢ in 2003. Crown and SpectraSite would not comment on buyout rumors.

CLEARER RECEPTION

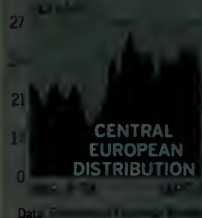


Looking Way Past Vodka in Poland

CENTRAL EUROPEAN DISTRIBUTION (CEDC) is a play on spirits—the intoxicating kind. It is the top distributor of vodka in Poland and a big importer of whiskey, wine, and beer. Based in Warsaw, its NASDAQ-traded stock is on the rise in a soggy market, up from 18.74 in May (adjusted for a 3-for-2 split in June) to 23.31 a share. “It’s a gem of a value play: still off the radar of big investors—and underpriced,” says Steve Cohen of investment firm Kellner DiLeo Cohen, which owns shares. With Poles favoring imported beer and wine, which bring higher margins, Central’s profits should expand further, says Cohen. Beverage sales have jumped in Poland since it joined the European Union, which cut—and in some cases scrapped—duties on

liquor imports. Joining the EU, says Cohen, could pave the way for Central to penetrate European markets. His 12-month target for the stock is 36, based on earnings forecasts of \$1.30 in 2004 and \$1.55 in 2005, vs. 96¢ in 2003. Investment firm Brean Murray, which has done banking for Central and rates it a buy, notes the company has met with Polish brass to buy Poland’s biggest—state-owned—vodka distiller. That would make Central a producer-distributor—which should boost its stock.

BOTTOMS UP



Why ABX Air Is Really Delivering

SINCE BEING ACQUIRED in 2002 by Deutsche Post, DHL Worldwide Networks has upped its business: It has become more visible in the U.S.—and was the official express delivery service of the U.S. Olympic team in Athens. One outfit profiting from DHL’s newfound energy: ABX Air (ABXA), an air-cargo carrier with a fleet of 116 planes that provides DHL with airlift and sorting services. With about 95% of ABX’s revenues coming from DHL, recent Deutsche Post outlays to promote DHL in the U.S. assure ABX of steady sales, says Ben Segal, president of Winchester Capital Management, which owns shares. Deutsche Post has said it will spend \$1.2 billion to expand DHL. “ABX is still undiscovered by the Street,” says Segal, who thinks the stock could double in a year, figuring it could earn 58¢ a share in 2004 and 70¢ in 2005. In August, ABX won a contract to manage the U.S. Postal Service’s handling operations in Indianapolis. ABX had revenues of \$1.1 billion last year. Previously a unit of air-freight company Airborne, ABX was spun off soon after Airborne was acquired by DHL. The stock is at 6.18, up from 3.50 in May. ■

AT HIGH ALTITUDE



BusinessWeek online

Gene Marcial’s Inside Wall Street is posted at businessweek.com/today.htm at 5 p.m. EST on the magazine’s publication day, usually Thursdays. See Gene on Fridays at 1:20 p.m. EST on CNNfn’s *The Money Gang*.

Note: Unless otherwise noted, neither the sources cited in Inside Wall Street nor their firms hold positions in the stocks under discussion. Similarly, they have no investment banking or other financial relationships with them.

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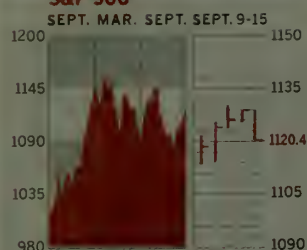
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Personal Business Figures of the Week

STOCKS

S&P 500



COMMENTARY

Rising oil prices sent stocks skidding at the start of the week. But markets settled down and headed higher until Sept. 15, when Coca-Cola warned it would miss profit targets for the quarter. Shares of the soft-drink maker hit a 52-week low on the news. For the week, the Dow fell 0.8%, while the NASDAQ and the S&P 500 advanced 2.5% and 0.4%, respectively.

Data: Bloomberg Financial Markets, Reuters

U.S. MARKETS

	SEPT. 15	WEEK	% CHANGE YEAR TO DATE	LAST 12 MONTHS
S&P 500	1120.4	0.4	0.8	10.4
Dow Jones Industrials	10,231.4	-0.8	-2.1	8.3
NASDAQ Composite	1896.5	2.5	-5.3	2.8
S&P MidCap 400	588.1	1.0	2.1	13.1
S&P SmallCap 600	288.0	1.7	6.5	17.3
DJ Wilshire 5000	10,920.3	0.6	1.1	10.9

SECTORS

	SEPT. 15	WEEK	% CHANGE YEAR TO DATE	LAST 12 MONTHS
BusinessWeek 50*	648.4	0.9	4.2	10.8
BW Info Tech 100**	328.8	2.3	-6.2	2.2
S&P/BARRA Growth	546.5	0.5	-1.7	5.3
S&P/BARRA Value	569.7	0.2	3.2	15.7
S&P Energy	265.6	1.5	18.5	33.8
S&P Financials	390.1	-0.2	2.7	14.8
S&P REIT	126.1	-3.2	8.9	18.8
S&P Transportation	205.8	0.3	1.9	14.8
S&P Utilities	126.3	-0.2	6.7	16.2
GSTI Internet	146.4	5.4	1.2	8.2
PSE Technology	673.7	3.0	-3.4	5.8

*Mar. 19, 1999=1000 **Feb. 7, 2000=1000

GLOBAL MARKETS

	SEPT. 15	WEEK	% CHANGE YEAR TO DATE	LAST 12 MONTHS
S&P Euro Plus (U.S. Dollar)	1168.3	0.3	-0.9	17.3
London (FT-SE 100)	4548.4	-0.2	1.6	6.7
Paris (CAC 40)	3691.9	0.4	3.8	10.6
Frankfurt (DAX)	3941.8	1.5	-0.6	12.1
Tokyo (NIKKEI 225)	11,158.6	-1.1	4.5	2.5
Hong Kong (Hang Seng)	13,084.4	0.3	4.0	18.2
Toronto (S&P/TSX Composite)	8467.0	1.3	3.0	11.8
Mexico City (IPC)	10,660.9	1.2	21.2	37.9

FUNDAMENTALS

	SEPT. 14	WEEK AGO	YEAR AGO
S&P 500 Dividend Yield	1.70%	1.70%	1.62%
S&P 500 P/E Ratio (Trailing 12 mos.)	20.0	19.8	28.8
S&P 500 P/E Ratio (Next 12 mos.)*	16.5	16.3	16.7
First Call Earnings Revision*	-0.23%	-0.04%	0.57%

*First Call Corp.

TECHNICAL INDICATORS

	SEPT. 14	WEEK AGO	READING
S&P 500 200-day average	1115.0	1113.1	Positive
Stocks above 200-day average	59.0%	58.0%	Neutral
Options: Put/call ratio	0.77	0.80	Positive
Insiders: Vickers NYSE Sell/buy ratio	3.37	3.22	Negative

BEST-PERFORMING GROUPS

	LAST MONTH %		LAST 12 MONTHS %
Internet Retail	21.6	Internet Software	89.5
Internet Software	19.6	Steel	87.3
Application Software	15.9	Internet Retail	74.6
Computer Stores	15.6	Oil & Gas Refining	66.8
Oil & Gas Drilling	15.3	Homebuilding	57.4

WORST-PERFORMING GROUPS

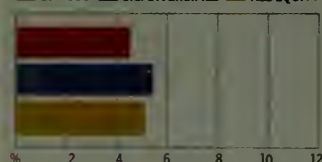
	LAST MONTH %		LAST 12 MONTHS %
Food Wholesalers	-6.9	Airlines	-29.8
Soft Drinks	-5.1	IT Consulting	-25.3
Brewers	-2.6	Semiconductor Equip.	-22.8
Environmental Services	-2.4	Semiconductors	-19.2
Home Entertainment	-1.7	Health-Care Distribtrs.	-16.7

MUTUAL FUNDS

4-WEEK TOTAL RETURN

WEEK ENDED SEPT. 14

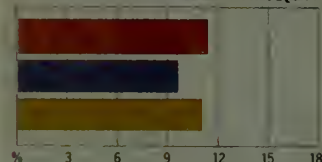
■ S&P 500 ■ U.S. DIVERSIFIED ■ ALL EQUITY



52-WEEK TOTAL RETURN

WEEK ENDED SEPT. 14

■ S&P 500 ■ U.S. DIVERSIFIED ■ ALL EQUITY



Data: Standard & Poor's

EQUITY FUND CATEGORIES

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		LEADERS	
Technology	9.0	Natural Resources	35.4
Diversified Emerg. Mkts.	8.1	Latin America	31.0
Small-cap Growth	8.0	Real Estate	25.3
Natural Resources	7.7	Europe	24.0
LAGGARDS		LAGGARDS	
Domestic Hybrid	2.9	Technology	-4.5
Miscellaneous	3.0	Small-cap Growth	3.7
Real Estate	3.1	Large-cap Growth	4.6
International Hybrid	3.1	Mid-cap Growth	5.3

EQUITY FUNDS

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		LEADERS	
ProFds. Intnet. Ultsr. Inv.	19.2	iShares MSCI Austria Idx.	60.2
Reynolds	18.2	ProFds. Wrllsr. Ultsr. Inv.	57.6
American Heritage Growth	16.7	State St. Rsch. Gl. Rs. B	54.4
ProFds. Ult. Sm. Cap Inv.	16.0	ProFunds Energy Utr. Inv.	54.2
LAGGARDS		LAGGARDS	
GMO Asia III	-44.0	ProFds. Smicdr. Ultsr. Inv.	-35.0
ProFds. USh. Sm. Cap Inv.	-14.6	GMO Asia III	-34.2
ProFunds UltSh. OTC Inv.	-13.8	Ameritor Investment	-32.4
Rydex Dynam. Vent. 100	-13.8	Thurlo Growth	-32.0

INTEREST RATES

KEY RATES

	SEPT. 15	WEEK AGO	YEAR AGO
Money Market Funds	1.09%	1.04%	0.61%
90-Day Treasury Bills	1.66	1.64	0.94
2-Year Treasury Notes	2.48	2.47	1.61
10-Year Treasury Notes	4.16	4.16	4.18
30-Year Treasury Bonds	4.96	4.96	5.09
30-Year Fixed Mortgage †	5.68	5.80	6.38

†Barr's Quote Inc

BLOOMBERG MUNI YIELD EQUIVALENTS

Taxable equivalent yields on AAA-rated, tax-exempt municipal bonds, assuming a 30% federal tax rate.

	10-YR. BOND	30-YR. BOND
General Obligations	3.57%	4.59%
Taxable Equivalent	5.10	6.56
Insured Revenue Bonds	3.73	4.87
Taxable Equivalent	5.33	6.96

THE WEEK AHEAD

RESIDENTIAL CONSTRUCTION

Tuesday, Sept. 21, 8:30 a.m. EDT » August housing starts are forecast to have inched lower, to an annual rate of 1.94 million. That's based on the median forecast of economists surveyed by Action Economics. In July, sales climbed to an annual pace of 1.98 million. **FOMC MEETING Tuesday, Sept. 21 9 a.m. EDT** » The Federal Reserve Board's Open Market Committee will meet to set

monetary policy. Economists surveyed by Action Economics expect the Fed will hike rates to 1.75%, up from 1.5%.

LEADING INDICATORS Thursday, Sept. 23, 10 a.m. EDT » The Conference Board's August index of leading economic indicators most likely slipped by 0.1%, after a 0.3% decline in July.

DURABLE GOODS ORDERS Friday, Sept. 24, 8:30 a.m. EDT » New durable goods orders for

August probably rose 0.4%. A leap in nondefense aircraft orders pushed orders up by 1.6% in July.

EXISTING HOME SALES Friday, Sept. 24, 10 a.m. EDT » Existing home sales in August probably slowed to an annual pace of 6.64 million. July sales touched an annual rate of 6.72 million. Existing home sales are likely to set another record in 2004, aided by the muted increases in mortgage rates so far this year.

The *BusinessWeek* production index improved to 227.1 for the week ended Sept. 4, an increase of 13.9% from the previous year. Before calculation of the four-week moving average, the index rose to 230.1.

BusinessWeek online

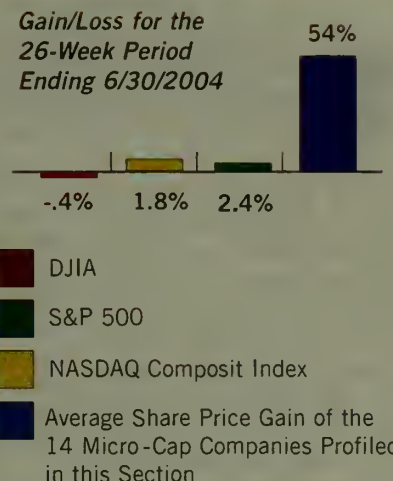
For the BW50, more investment data, and the components of the production index visit www.businessweek.com/magazine/extra.htm

THE EQUITY INVESTOR'S 26-WEEK MICRO-CAP REVIEW

SELECTED PROFILES OF THE NATION'S TOP PRICE-PERFORMING MICRO-CAP COMPANIES AS OF 6/30/04

From the approximate 2,700 domestic companies with market capitalizations under 200 million dollars, the following pages highlight selected top-ranking firms, in terms of share price performance for the 26-week period ending 6/30/04. Each profile describes a leading company including its industry, market trends and reasons for success, as written by company management. While past performance is never a guarantee of future results, these top-performing companies represent investment opportunities worthy of a micro-cap investor's close consideration.

Gain/Loss for the
26-Week Period
Ending 6/30/2004



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Key Manager Statement

"Baldwin Technology is a leading provider of innovative products to the printing industry."

The Company aggressively pursues the commercialization of its development activities to further its position in the marketplace. We are committed to continuing the business momentum achieved in Fiscal 2004 during our next fiscal year and into the future."

Gerald A. Nathe
Chairman & CEO

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Sustained focus on meeting client needs and its outsourcing and consulting strategy has gained Superior increased recurring revenue, 200% second quarter outsourcing and consulting bookings growth over last year, and a seventh consecutive quarter of in-line performance.

Key Manager Statement

"A heightened focus on healthcare has prompted government and industry leaders to look to information technology for quality and cost improvement. As a healthcare I.T. authority and industry leader, Superior is well-positioned to capitalize on this growing market."

Richard D. Helppie, Founder & CEO

UFPT Technologies, Inc. • UFPT • Manufacturing

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UFPT Technologies is an innovative designer and custom converter of foam, plastics and natural fiber products. UFPT provides industry-leading solutions from ten engineering and manufacturing facilities in North America. The company's Engineered Packaging division provides custom protective packaging for the medical, electronics, automotive, military and industrial markets. UFPT's Component Products division designs and manufactures engineered component solutions utilizing laminating, molding and fabrication technologies. This division provides the "product within the product" to the automotive, beauty, medical, industrial, and sports and leisure markets.

Key Manager Statement

"UFPT is very well positioned for growth. With the largest automotive contract in our history scheduled to launch in late 2004 and numerous marketing and sales initiatives already yielding strong results – all overlaid on a leaner, more efficient company structure – we are excited about our future."

Jeff Bailly, President & CEO

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Versar, Inc. (VSR) is a leading national defense and infrastructure revitalization firm addressing critical security, health and safety issues facing government and industry today and into the future. Versar provides services and products for military defense, homeland security, environmental remediation and specialized construction. In today's dangerous environment, Versar's experience in the control of toxic and hazardous materials, including weapons of mass destruction, helps customers deal with modern problems using proven solutions and technology. Its experience ranges from providing protective equipment to the Athens Olympics' security forces, to designing and building secure mail handling facilities, to the remediation of contaminated military locations to create a safe and secure environment for our society.

Key Manager Statement

"Versar provides solutions to client security and infrastructure problems around the world. We see a growing need for our services and products, as the future brings us new challenges every day. Versar stands ready to answer these challenges with the best scientific an engineering talent available."

Ted Procvic, President & CEO

THE EQUITY INVESTOR'S 26-WEEK MICRO-CAP REVIEW

Valentis, Inc. • VLTS • Biotechnology

Burlingame, CA • IR Contact: Joe Markey Dir. of Finance • 650-697-1900 x369
www.valentis.com



Valentis is focused on the creation of innovative cardiovascular therapeutics. Valentis' lead product, Deltavasc™, is currently in Phase II clinical trials in patients with peripheral arterial disease, a highly prevalent disease with very limited treatment options. Valentis has a series of proprietary technologies that allow the Company to generate novel therapeutics to treat a wide range of diseases via therapeutic angiogenesis (stimulation of new blood vessel growth). In addition to Valentis' cardiovascular programs, industry leaders have licensed rights to Valentis' technologies and are utilizing them for the development of therapeutics to treat a variety of indications including infectious diseases and cancer.

Key Manager Statement

"Deltavasc™ is a product that stimulates new blood vessel formation and presents meaningful opportunities for the treatment of a number of cardiovascular diseases where current treatment options are limited. Initial applications of Deltavasc™ include peripheral arterial disease, ischemic heart disease and diabetic neuropathy."

Benjamin F. McGraw, III, Chairman, President & CEO

Natural Alternatives Intl., Inc. • NAI • Nutritional Supplements

San Marcos, CA • IR Contact: John Reaves • 760-744-7340
www.nai-online.com • investor@nai-online.com



Natural Alternatives International (NAI) is an established leader in formulating, manufacturing, and packaging nutritional supplements sold to consumers in North America, Europe, Asia, and Australia. Founded in 1980, NAI has a reputation for quality built on science-based product formulations, regulatory certifications of its manufacturing operations, and strategic partner services including clinical studies, regulatory assistance, and international product registration. During our fiscal year ended June 30, 2004, net sales grew 40% to \$78 million and operating income margin doubled to 4.3% compared to the prior fiscal year.

Key Manager Statement

"Executing our strategies to increase revenue, improve financial performance, and strengthen capitalization has provided the foundation for long-term growth. Our commitment to science-based formulations and investment in customized partner services enhances our competitive advantages and our ability to attract customers worldwide."

Mark LeDoux, Chairman & CEO

Marsh Supermarkets, Inc. • MARSA, MARSB • Food Retailer

Indianapolis, IN • IR Contact: Don E. Marsh • 317-594-2100
www.marsh.net



Marsh Supermarkets, Inc. is one of the nation's largest regional grocery chains with 278 various stores in central Indiana and western Ohio. Other ventures include banquet catering, convenience stores with fuel, vending machine service, and floral retail outlets. In the fiscal year just completed, Marsh posted total revenues of \$1.65 billion with net income of \$3.03 million and total assets of \$524.4 million. Known for innovation, Marsh was first in the industry to use a laser scanner and UPC bar code to price groceries (1974), and was first in its marketing area to offer discounts at checkout using a loyalty card (Fresh IDEA card). Marsh also is a leader in customer relations marketing, international food promotion, corporate philanthropy and community involvement.

Key Manager Statement

"We constantly look for new trends and fresh ideas to better serve our customers and we will do whatever is necessary to remain an industry leader."

**Don E. Marsh
Chairman & CEO**

IA Global, Inc. • IAO • Media, Entertainment & Technology

Burlingame, CA • IR Contact: Mark E. Scott, CFO • 650-685-2403
www.iaglobalinc.com



IA Global, Inc. is a public holding company focused on acquiring Japanese and U.S. companies that operate in the entertainment, media and technology areas. IA Global holds a 60.5% equity interest in Rex Tokyo Ltd., a supplier and maintenance contractor of parts to the Pachinko and slot machine gaming industry in Japan. Through its 67% equity interest in Fan Club Entertainment Ltd., IA Global provides advertising, publishing and data management services to the official Fan Club in Japan for Marvel Entertainment Inc. and Marvel Characters Inc. IA Global holds a 90% equity interest in QuikCAT, a leading multi-media compression technology company, which has developed several patent video, picture and audio compression algorithms (codecs).

Key Manager Statement

"We are extremely pleased with our results for the second quarter of 2004. Revenues increased to \$9,382,000 from \$99,000 in the second quarter of 2003. The net loss decreased to \$295,000 from \$804,000 in the second quarter of 2003. Net income was \$39,000 without one-time merger and acquisition and fixed asset write-down charges."

Alan Margerison, CEO

Hemisphere Biopharma, Inc. • HEB • Biopharmaceutical

Philadelphia, PA • IR Contact: Dianne Will • 518-398-6222
www.hemisphere.net



Hemisphere Biopharma, Inc. is a biopharmaceutical company engaged in the clinical development, manufacture, marketing and distribution of drug entities based on natural immune system enhancing technologies. Its lead compounds are Alferon N Injection®, a natural form of human leukocyte derived Interferon currently approved by the FDA for a category of sexually transmitted diseases (STDs) and Ampligen®, an experimental nucleic acid, which is in a Phase 2b clinical study for HIV and a recently completed Phase 3 clinical study for Chronic Fatigue Syndrome (CFS). Alferon N® and the experimental agents Alferon LDO, Ampligen and Orageris provide a broad experimental platform of immune based therapies that show substantial potential in CFS, HIV, Hep-C, STDs and Bioterrorism.

Key Manager Statement

"Globally, we are successfully pursuing major markets in life threatening and severely debilitating infectious diseases; including CFS for which no approved therapy yet exists; these rapidly expanding diseases represent a huge unmet medical need."

**William A. Carter, M.D.,
Chairman & CEO**

American Independence Corp. • AMIC • Health Reinsurance

New York, NY • IR Contact: David T. Kettig • 212-355-4141 x3047
www.americanindependencecorp.com



American Independence Corp. is a leading provider of excess health insurance for self-insured employer group medical plans. Our products allow employers to manage the risk of today's ever-increasing health insurance costs by limiting their expenses to a predetermined amount, while affording employers the flexibility to design health coverages that best suit their needs and those of their employees. With no debt and a strong balance sheet, our management has focused on accelerating growth so as to utilize our federal net operating loss carryforwards (NOLs) of over \$287 million, which were generated from prior non-insurance operations.

Key Manager Statement

"Our experienced management team has positioned AMIC to grow through our captive distribution force and established reinsurance relationships with an overriding goal of underwriting profitability. We do not expect to pay Federal income taxes for many years, due to utilization of our NOLs, so we encourage investors to focus on how much cash we generate to better understand the value we bring to our shareholders."

Roy T.K. Thung, President & CEO

THE EQUITY INVESTOR'S 26-WEEK MICRO-CAP REVIEW

Qualstar Corporation • QBAK • Data Storage

Simi Valley, CA • IR Contact: Frederic T. Boyer, CFO • 805-583-7744
www.qualstar.com

Qualstar is a manufacturer of automated tape libraries used for backup, archival storage, data protection and disaster recovery. The company's products are known through-

out the world for their rugged, *Simply Reliable* design yielding years of trouble-free operation. A complete family of 30 models spans a very broad range of data storage requirements, for a single department or the complete enterprise. Qualstar tape libraries are sold, installed and supported worldwide by selected Value Added Resellers, Systems Integrators, Distributors and Original Equipment Manufacturers. Qualstar also designs, manufactures and sells ultra small, high efficiency open-frame switching power supplies under the "N2Power" brand name to OEMs.

Key Manager Statement

"Our customers count on us to store, protect and retrieve their business-critical data. Founded in 1984, we have a 20 year track record of delivering reliable, cost-effective storage solutions, worldwide. Our tape libraries are the key enabling technology for archiving high volumes of regulatory compliance data, video security systems images and fixed-content information."

William Gervais
President & CEO

Brooke Corporation • BXX • Franchising

Overland Park, KS • IR Contact: Kyle Garst • 913-661-0123 x121
www.brookecorp.com • garstk@brookecorp.com



Brooke Corporation has over 300 franchise locations and was recently rated by industry publications as the #1 franchisor in its industry category, 66th fastest growing US franchise, and 47th largest US insurance broker. Brooke believes that the opportunity for business ownership provided through its franchise program is the ultimate tool for rewarding sales performance and motivating insurance professionals. Therefore, Brooke's primary mission is to enable insurance professionals to purchase businesses through acquisition financing and help insure business success through a proven business model, expert advice and administrative assistance.

Key Manager Statement

"Our franchise program 'levels the playing field' for local business owners and has gained increasing popularity with insurance professionals as demonstrated by the 63% increase in 2003 revenues from the previous year."

Robert Orr, Chairman & CEO

GSE Systems • GVP • Simulation Services

Columbia, MD • IR Contact: John Moran • 410-772-3589
www.gses.com



GSE Systems, Inc is a world leader in real time, high fidelity computer simulation. Its roots can be traced back to 1929 when the first flight simulator was delivered to the US Army. Since that time

GSE has developed a dominating global position in nuclear power plant simulators with more than twice the installed capacity of all competitors combined. They also deliver simulators to the chemical, petrochemical and process industries worldwide. Over one million plant operators in 35 countries have trained and qualified on GSE simulators in some of the most challenging operating environments imaginable. Today, they simulate Homeland Defense Emergency Operations Centers in the US, refineries in the Middle East, nuclear remote shutdown panels in the Ukraine, and in the health care sector they recreate a physician's home office on a handheld device allowing doctors access to patient records, lab tests and other important data from any location in the world.

Key Manager Statement

"The rapidly decreasing cost of computing power is driving significant growth in simulation. We've invested heavily in our technology and are well positioned to participate in this growth sector."

John V. Moran, CEO

DIRECTORY

Selected Top Price-Performing Micro-Cap Companies as of 6/30/04

American Independence Corp	212-335-4141 x3047
Baldwin Technology	203-402-1000
Brooke Corporation	913-661-0123 x121
GSE Systems	410-772-3589
Hemispherx Biopharma	518-398-6222
IA Global	650-685-2403
Marsh Supermarkets	317-594-2100
Natural Alternatives	760-744-7340
Qualstar Corporation	805-583-7744
Superior Consultant Company	248-386-8300
UFP Technologies	cjarvis@ufpt.com
Valentis, Inc.	650-697-1900 x369
Versar, Inc.	703-642-6712

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Getting Politics Out of the Courts

THE POISONOUS POLARIZATION that has infected America's political system is now undermining the one branch of government that is supposed to be impartial—the judiciary. The constitutional role of the courts as a check on the power of the elective branches of government is being eroded. Traditions of civility, decorum, and respect for the rule of law that give the judiciary its moral authority are giving way to special interests, political litmus tests, and money politics.

Public trust in the judiciary is nearing an all-time low. The partisanship must end before American society is left without any checks and balances and the expectation of a fair trial is a memory of a bygone era (page 36).

Conservatives and liberals, of course, have been battling over the federal judiciary for much of the country's history. President Franklin D. Roosevelt threatened to pack the Supreme Court in the 1930s when it opposed the Social Security Act and other New Deal legislation. In the end, Roosevelt triumphed. President Ronald Reagan appointed conservative Supreme Court judges in the 1980s to roll back liberal Supreme Court decisions made in previous decades.

But past political conflict was mostly over broad

philosophical principles: the role of government in the lives of individuals, the interpretation of the Constitution in modern life, federal vs. state power. Distinguished federal judges were appointed who saw themselves representing the law, not specific policies, and varied their opinions on the bench.

Today judges are increasingly vetted on their positions on

abortion, tort reform, affirmative action, and gay marriage before they're even considered for federal positions. And where conservatives and liberals once battled over Supreme Court appointments, they now fight over lower appeals court positions as well. Congressional Democrats filibuster to block candidates while the President appoints them during Senate recesses.

It's worse at the state level, where 38 states elect judges.

There, judicial candidates run TV attack ads and take big campaign gifts from special interests. In a poll of 894 elected judges conducted in 2001 and 2002 by a nonpartisan watchdog group, 46% said donations influenced their judicial decisions. This threatens the core of our justice system.

So bad is the situation that the American Bar Assn. is pushing for publicly funded campaigns for state judges. North Carolina is the first to agree. Other state bar associations are creating bipartisan watchdog panels to monitor misleading ads and overtly partisan rhetoric. Making public all campaign contributions in judicial races is also important. But much more must be done, especially at the federal level. There's still time to stop the undermining of the judiciary—but not much.

50 Ways to Help The Uninsured

IT'S TIME TO DECONSTRUCT THE HEALTH-care crisis in America. For people who work for big corporations, the problem is costs, which keep going up. For employees of small businesses, the problem is not only costs but access, which keeps going down. The latest statistics show that large companies are maintaining health-care insurance for their workers while passing on a greater share of rising costs. But the percentage of small companies offering health insurance is falling sharply. Nearly three out of four of the 45 million uninsured Americans work for small businesses or are dependents of these workers. In the campaign, President George W. Bush and John Kerry are proposing to help small business provide health insurance to their

workers. What is not being said is that much of the problem of the uninsured can be solved at the state, not federal, level.

Here's why. Each state regulates insurance within its own borders and mandates what kind of policies can be sold. Small businesses complain that these mandates often require them to buy expensive insurance that covers mental health, birth control, and many other medical problems. They want stripped down catastrophic insurance that is much cheaper. A few states are helping small businesses by subsidizing premiums. But all states can help by allowing insurance companies to sell limited policies to cover just hospital care (page 48).

In addition, 10 million of the nation's 45 million uninsured are already covered by state Medicaid and State Children's Health Insurance Programs, but are not enrolled. Many are working poor employed by small businesses that don't offer health insurance. States have done little to reach out to these uninsured, leaving them to use expensive hospital emergency rooms to treat colds. This only drives up costs for everyone.

Both Bush and Kerry want to help small businesses provide health insurance by pooling their risks to buy coverage in a single national market, rather than 50 small markets. This could lower costs. Yet both would do well to insist that states do their part in dealing with the uninsured. They are part of the problem and can be part of the solution.

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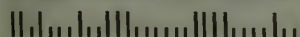
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FUZZY NUMBERS

Despite the reforms, corporate profits can be as distorted and confusing as ever. Here's how the game is played. **BY DAVID HENRY (P.78)**

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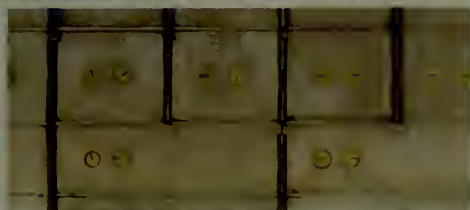
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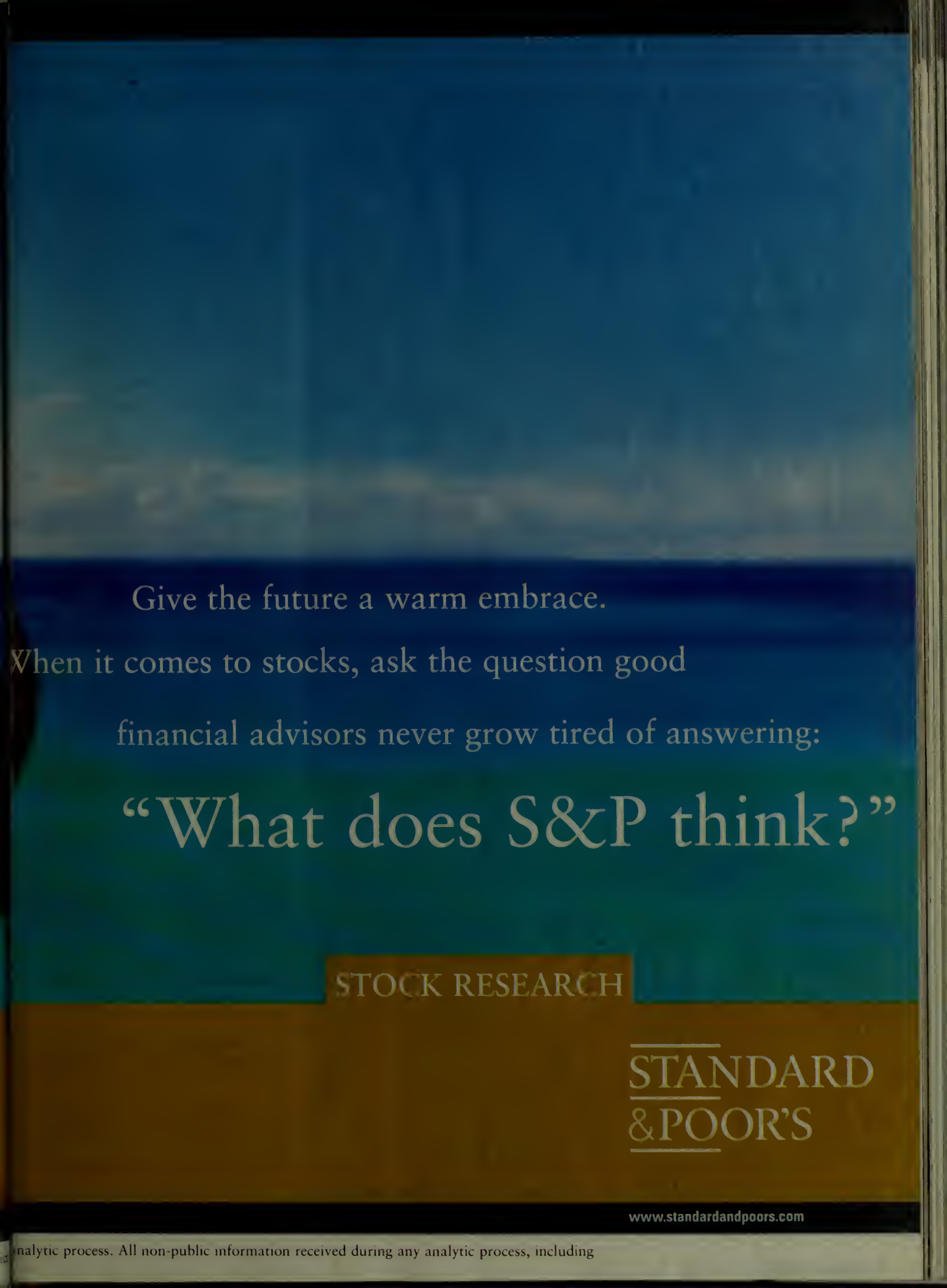
Rockwell
Collins

A romantic couple is shown in profile, kissing on a beach. The scene is bathed in the warm, golden light of a sunset or sunrise, with the ocean visible in the background. The couple's faces are close together, and their lips are touching. The man has dark, curly hair, and the woman has blonde hair. The overall mood is intimate and serene.

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Corporate America Is Hardly Ready for Sarbanes-Oxley

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A Firefox Let Loose in Internet Explorer's Henhouse

Though the Mozilla Web browser's share is still small, this open-source effort is winning over plenty of converts wary of security holes in Microsoft's dominant product



Finding Lost Retirement Resources

It's amazing how many people have misplaced financial assets—stocks and bonds, bank accounts, uncashed checks, pensions, 401(k)s, and utility deposits—that should be part of their savings. Here's how to avoid that fate

Is Outsourcing About to Become Outmoded?

The wide wage gap between the U.S. and Asia is quickly narrowing, so the cost savings of sending work overseas may soon diminish



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—Theodore Wells, Philip Morris USA lawyer, on tobacco's new attitude, during a \$280 billion racketeering case against the industry

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PROXY MOXIE TELL 'EM HOW TO VOTE THE SHARES

STEVEN WALLMAN, who had a reputation as an iconoclast when he served on the Securities & Exchange Commission in the 1990s, is now taking on the proxy-advice business. In January, Wallman will launch **Proxy Governance** to advise institutions and investment managers on how to vote their shares on corporate governance issues.

The timing looks good for challenging market leader **Institutional Shareholder Services (ISS)**. Demand is taking off, thanks to new SEC rules. And some investors welcome Proxy Governance's plan to evaluate issues company by company—in contrast to ISS, which applies common guidelines to all companies. "We don't subscribe to the

view that it's always good to [eliminate] poison pills or separate the role of the chairman and CEO," says Wallman.

But rivals are already blasting Proxy Governance for potential conflicts in its marketing deals and approach. **The Business Roundtable**, an association of big-company CEOs, has purchased a bulk subscription for its member companies, whose pension plans vote thousands of proxies. Critics carp that this amounts to an equity stake by companies that the firm will judge.

Nonsense, says Wallman, who argues that the Roundtable is merely a subscriber. ISS execs, meanwhile, say Proxy Governance's plan to use different yardsticks for different companies will invite charges that its analysis is unfair. Corporate governance advice is turning into a cutthroat field of its own.

—Amy Borrus



IRAQ Keeping the Army in touch by laptop

MILITARY INFO

One Uniform Tech Network?

DEFENSE CONTRACTORS and technology companies are banding together to bring their vision of a network-centric military closer to reality. *BusinessWeek* has learned that on Sept. 28 industry titans **Boeing, Cisco Systems, General Dynamics, Microsoft, IBM**, and 23 others will announce the creation of a consortium aimed at creating common standards for a single network that could weave all three military branches into a seamless, digital whole. Says Kevin G. Coleman, a senior fellow at **Technolytics Institute**, a think tank that specializes in network technology: "This could substantially change the way we wage war."

If it works, that is. The project faces daunting odds—from the technical difficulties of building a secure, reliable network to the political headache of getting the competing branches of the military to agree to one standard and share information.

Military planners say an open system like the Web would let contractors focus more on perfecting weapons and less on designing the software they run on. Standards would cut costs for the government and boost company margins—an incentive for cooperation if ever there was one.

—Stanley Holmes



WEB WORLD

CHIPPING AWAY AT MICROSOFT

FOR THE FIRST TIME in more than seven years, **Microsoft** is losing Web-browser market share. According to the Web-



BILL GATES

site analysis service **WebSideStory**, Microsoft's share of browser users who visited top sites shrank from 95.6% in June to 93.7% in September. Meanwhile, people using free browsers made by the **Mozilla** open-source software group grew from 3.5% to 5.3%.

There's no mystery why the Mozilla Web browsers are suddenly growing. On Sept. 19, security software maker **Symantec** reported that the number of new viruses aimed at Windows—which includes Microsoft's Internet Explorer (IE) browser—rose to 5,000 in the first half of the year, up from 1,000 in the same period last year. In June, the government's **Computer Emergency Readiness Team** warned Web surfers to stop using IE, after Microsoft disclosed a bug that allowed spyware to be downloaded to people's computers without their involvement.

The Mozilla people hope to increase momentum with the

release this fall of a new version of their browser, called Firefox 1.0. It's a superfast browser with few virus problems. Consumers have downloaded 1.3 million copies of the most recent preview version of the browser since it became available on Sept. 14.

Of course, Microsoft is in little danger of being toppled from the top spot—at least, not anytime soon. The software giant insists that fixes for Windows XP released in August substantially reduce its vulnerability to attacks. But unless consumers notice a dramatic change for the

better, Firefox could really begin to catch fire—and outfox IE.

—Steve Hamm

PILL PRICES

WHAT GOES UP... Drugmakers may be tapping the brakes on price hikes. Drug distributors McKesson and Cardinal Health recently warned of weaker-than-expected earnings, in part because drug company suppliers are putting through fewer price increases on prescription drugs. Why the slowdown? **Pharmaceutical** players may not want to draw fire as new Medicare rules are crafted and as the election nears. And even if Big Pharma resumes aggressive pricing after Nov. 2, it will become more difficult to play that game in the years ahead because of crowded markets, weak pipelines, and the launch of the new Medicare drug benefit.

—Amy Barret

DRAWN & QUARTERED



"YEAH, I THINK WE'RE ALL A LOT SAFER SINCE THE ASSAULT WEAPONS BAN EXPIRED"



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FACE TIME

TIM FINCHEM



A VIEW FROM THE FAIRWAY

For many fans, the golf season ended with a thud: Europe drubbing the U.S. team in the Ryder Cup on Sept. 19. But Commissioner **Tim Finchem**, 57, in his 10th year at the helm, presides over a PGA Tour that's richer than ever. Prize money climbed to \$240 million this year, and 64 golfers have earned \$1 million or more. Here's Finchem...

On the PGA Tour's prize money, which has increased five-fold since 1994:

"I'd like to think there will be some growth. But it will be much flatter than it has been in the past 10 years."

On Tiger Woods's cooling off:

"Tiger is still the biggest thing in golf. He sells a lot of tickets. If he's not in the hunt, you do not get that spike [in TV ratings]."

On post-Ryder Cup outcries:

"It's the typical American response: If you have an Enron, there must be something wrong with the system. So let's pass Sarbanes-Oxley and change the system. We overreact."

—Mark Hyman

For an extended version, go to www.businessweek.com/magazine/extra.htm

SWEET MUSIC

ON TOP OF THE WORLD AT UNIVERSAL

AFTER 40 YEARS in the mosh pit that is the music business, **Universal Music Group (UMG)** Chairman Doug Morris says he's still having a blast. His popular hip-hop artist, Nelly, has two new albums, *Suit* and *Sweat*, hitting the *Billboard* charts at No. 1 and No. 2. The last act with that kind of one-two punch was Guns N' Roses 13 years ago. Says Morris with a chuckle: "This is just fun, isn't it?"

There's more good news. *BusinessWeek* has learned that UMG's parent, Paris' **Vivendi Universal**, is prepared to sign Morris, 65, to a new five-year contract by mid-October. The new pact, say sources close to UMG and Vivendi, could be worth more than \$70 million if Morris hits certain targets. Morris declined comment—but said he wouldn't be retiring anytime soon. Vivendi officials were mum. The \$5



NELLY *Suit* and *Sweat* are hits

billion-a-year UMG's future was hazy after

Vivendi sold most of its U.S. entertainment properties to **NBC** in May. But Vivendi execs say they are committed, especially with a 7% uptick in album sales in the first half of 2004, the first gain in years.

There's still plenty of work for Morris to do: finishing up a \$300 million cost-cutting

initiative, increasing an emphasis on digital sales, and overseeing a strategy to cut CD prices to boost store sales. Some observers think Morris may one day orchestrate a management buyback if the French ever bail on UMG. He discusses this scenario now and then with **Apple's** Steve Jobs, a pal. No deal appears necessary, at least as long as Morris and his Paris bosses stay in sync. —Tom Lowry

AFTERLIVES

CLARK GUNS FOR HOME SECURITY

THE HOMELAND security business is still smokin'. *BusinessWeek* has learned that former **NATO** commander and Democratic Presidential wannabe General Wesley Clark has joined **Witt Associates**, a Washington consultancy headed by James Lee Witt, Clinton-era head of



THE GENERAL A consulting gig

the **Federal Emergency Management Agency**.

Rodney Slater, Clinton's Transportation Secretary, also has joined Witt's company, which specializes in homeland security and public safety. Slater and Clark will be vice-chairmen. The three-year-old firm

recently evaluated evacuation plans at New York's Indian Point nuclear power plant. Of course, Clark's new gig could be short-lived if Kerry wins the election and taps him for a Cabinet post.

—Paul Magnusson

THE STAT

55

The percentage of working Americans who say they would continue to work even if they won a lottery jackpot to the tune of \$10 million.

Data: Gallup Tuesday Briefing



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Large Company Value* (ALVIX)	20.87%	—	—	5.24% / -1.68%	7/30/99
S&P 500	19.11%	-2.20%	11.83%	—	—

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The Great Innovators

CELEBRATING

75

As part of its anniversary celebration, BusinessWeek is presenting a series of weekly profiles of the greatest innovators of the past 75 years. Some made their mark in science or technology; others in management, finance, marketing, or government. In late September, 2004, BusinessWeek will publish a special commemorative issue on Innovation.

Supercharging Silicon Valley

MAYBE IT WAS A SIGN of the times. In 1968, with a nation at war and an entire generation questioning authority, two millionaires who should have been settling into content middle-aged lifestyles set off their own revolution. Robert N. Noyce had already co-invented the integrated circuit, the precursor to

microprocessors. And Gordon E. Moore had earned a reputation as a tech visionary. But unhappy with edicts handed down by the parent of Fairchild Semiconductor International Inc., which they helped found, they quit and took a young chemical engineer, Andrew S. Grove, with them. The shingle under which they would operate? Intel, short for integrated electronics.

Together, the trio changed the world. After IBM chose Intel processors to run its new PCs, they set a pace of technological innovation that is nothing short of breathtaking. Consider: While the first microprocessor Intel Corp. turned out in 1971 included 2,250 transistors, the company's chips now can be packed with 1.5 billion transistors each. That's like carmakers going from 23 miles per gallon to 15 million. The geometric surge in computing power has set off a digital revolution. It's what lets spreadsheets crunch numbers, browsers surf the Net, and PCs burn music tracks. Today, more than 80% of the world's 1 billion-plus PCs run on Intel chips.

But their mastery of the art of making chips is only part of the story. A meshing of three complementary minds helped create a remarkably adaptive company and a culture that has been imitated throughout the technology business. "Right from the start, we said we're not going to do it the way the industry does it," says Grove, 68, in an interview with *BusinessWeek*. "The willingness and confidence to act on an untried approach—that is the heart of the innovation of Intel as I see it."

Indeed, the troika decided the *modus operandi* in tech was

Intel's founding trio fashioned the building block for the digital revolution



GROVE, NOYCE, AND MOORE IN 1978

as antiquated as the vacuum tubes modern chips were replacing. They centralized manufacturing in giant chip fabrication plants. That helped them churn out chips at lower costs than companies that made custom chips in small factories. They dumped corner office rites due them and let arguments run wild. The process, dubbed "disagree and commit," encouraged engineers to constantly think of new ways of doing things faster, cheaper, and more reliably. And marketing later became a competitive weapon: The Intel Inside campaign made it a household name.

Despite those innovations, the chipmaker had its share of struggles. Massive Japanese investment in the chip industry nearly bankrupted the company in the 1980s. To raise money, Intel agreed in 1982 to sell 12% of the company to IBM for \$250 million, a stake it later repurchased. And in 1985, Grove and Moore decided to dump a memory business they had been in for nearly 20 years and focus on microprocessors. The decision laid the foundation for Intel's success today.

Noyce died of a heart attack in 1990. Moore, whose prediction that the number of transistors on a chip would double every 24 months earned him fame as the creator of Moore's Law, left Intel's board in 2001. And Grove is preparing to step down as chairman emeritus next year. "If it is hard to make a success out of something, it is an order of magnitude harder to sustain the success," he says. It's a lesson for companies in Silicon Valley and elsewhere. ■

—By Cliff Edwards

Siemens USA: energy & power • information & communication • medical solutions • lighting
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A woman with blonde hair, wearing a white tank top and light-colored shorts, is sitting on a wooden deck. She is looking down at a laptop computer. In the background, there is a large globe showing the Americas. The scene is lit with warm, golden light, suggesting sunset or sunrise. The deck has a wooden railing.

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In today's "throwaway worker" economy, many blue- and white-collar workers alike wish for ... job stability"

—Jim Morin
 Simpsonville, S.C.



FOR THE UNIONS, AN OPPORTUNITY—AND A CRISIS

ORGANIZED LABOR is in an environment of opportunity unprecedented since the 1930s. ("Can this man save labor?" Cover Story, Sept. 13). In today's "throwaway worker" economy, many blue- and white-collar workers alike wish for some measure of job stability, a more equitable sharing of pain between workers, management, and shareholders when economic conditions change or a company underperforms, and for fair opportunities for advancement and increased compensation when performance objectives are met. Unions, by and large, continue to respond with antiquated work rules, seniority-based compensation, and a unwillingness to look at new labor models that work with new economic realities.

When all the internal brouhaha settles down, one has to wonder whether there will be much left to work with.

—Jim Morin
 Simpsonville, S.C.

IN 1970, AS THE LAST president of American Locomotive Co. in Schenectady, N.Y., I spent two years in constant

negotiations with the Steelworkers, including a trial project that proved the company could compete with new methods and only half the people. But the union refused and struck, so we had no choice but to shut down and lay off hundreds of people.

During the 1950s, '60s, and '70s strikes were common, and American companies were in dire straits. Then we learned that the only way to stay in business was to outsource, starting what we now call "globalization." If Service Employees International Union President Andrew L. Stern could see that the best use of union strength would be to fight for a fair share of company profits, not to "kill the goose that lays the golden egg," American business and the American worker would be much better off.

With wise leadership, it would sell.

—Dick Ettington
 Palos Verdes, Calif.

AMERICA NEEDS GOOD ROADS, TO KEEP ON TRUCKIN'

YOUR EDITORIAL "Our take on the GOP's economic plans" (Sept. 6) is generally well-balanced. But calling the pending federal highway bill "egregious por-

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FRIDAY, AUGUST 29, 2003 - VOL. CCXLII NO. 43 - \$1.00

When it came to our tasting of "white goods," the superpremiums ruled the day. Here, our top three in each category, plus our tasters' comments:

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Most
Flavorful

Tanqueray No.
Ten \$26/750ml

Smoothest

Juniper Green
Organic
\$26.50/750ml

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Readers Report

CORRECTIONS & CLARIFICATIONS

In the chart accompanying "What's scaring Bush in these swing states" (News: Analysis & Commentary, Sept. 13), a map icon depicting Iowa was accidentally inserted where a map icon of Pennsylvania should have appeared.

barrel projects" misrepresents the measure and the importance of highway investment to the American economy. More than 80% of the nation's freight moves by truck. Highways account for 90% of passenger miles traveled each year. Without a safe, efficient highway system, the American economy would come to a grinding halt.

Congress proposes to invest \$280 billion to \$300 billion in highways and transit improvements during the next six years. This won't even help close the annual \$20 billion investment gap needed just to maintain current conditions, according to the U.S. Transportation Dept.

Cutting taxes is nice, but transportation investment is key to cranking up America's economic engine for the future.

-William Buechner

*Vice-President for Economics & Research
American Road & Transportation
Builders Assn.
Washington*

MORE LIGHT ON THE FUTURE OF SOLAR POWER

"ANOTHER DAWN for solar power" (Science & Technology, Sept. 6) covered only two major aspects of photovoltaics (PV): the current crystalline silicon efforts and the futuristic nanoparticle-based research. There is a third aspect that in some people's opinion will be more promising than either: thin films based on copper indium diselenide alloys, amorphous silicon alloys (briefly mentioned), and cadmium telluride.

PV devices based on these three semiconductors exist in multi-megawatt production and are growing rapidly. More important, they have the qualities needed to make PV cost-effective for energy-significant markets—a combination of excellent light-to-electricity conversion efficiencies, much lower manufacturing costs per unit area than existing wafer silicon options, and the potential for long outdoor durability. That is why research in these technologies has been heavily and consistently supported by the U.S. Energy Dept. through the National Renewable Energy Laboratory.

One or more of these technologies and

the U.S. companies that dominate them may turn out to be leaders in the future of photovoltaic electricity—and therein elevate the U.S. as leader in PV worldwide.

-Ken Zweibe

Manager

Thin Film PV Partnership

*National Renewable Energy Laboratory,
Golden, Colo*

THE SELF-EMPLOYED ARE NOT SCAMMING INSURERS

AS A MICRO-BUSINESS owner and president of the National Association for the Self-Employed (NASE), I was troubled to read "Enough to make you sick" (Social Issues, Sept. 13), regarding the "proliferation" of health-care insurance scams and your writer's implication that the NASE is one of those responsible for this problem.

Since 1981, the NASE has been a valued resource for the self-employed and micro-business community, providing legislative and regulatory advocacy, and services and benefits that previously were not available to micro-business owners. The NASE has co-sponsored the legislation for Association Health Plans, and it believes that more health-care tax credits, a self-employment tax deduction for health premiums, and other efforts that gear our nation's health care towards a more consumer-driven system are necessary to provide affordable, quality health coverage. The NASE offers more than 100 member benefits, and access to an insurance product is only one of them. The article's implication that a third-party vendor controls the NASE is ridiculous.

-Robert E. Hughes

*National Association for the
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How to reach BusinessWeek

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Books

The GOP Betrayed?

WHERE THE RIGHT WENT WRONG How Neoconservatives Subverted the Reagan Revolution and Hijacked the Bush Presidency

By Patrick J. Buchanan; Thomas Dunne/St. Martin's; 264pp; \$24.95

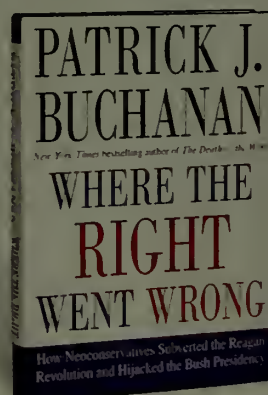
When you walk out of the revival tent of old-time conservatism that is *Where the Right Went Wrong*, you may find yourself feeling: 1. Stimulated (after viewing the world through night goggles that see the underbelly of free trade and the folly of American empire);

2. Fearful (about America's future in the hands of ideological zealots);
3. Bleary (after being bombarded with so many predictions and opinions);
4. All of the above.

You also may have the nagging sensation that the fast-talking preacher who just filled your ear was ultimately being dishonest—not only to the faithful but also to himself.

The election-year sell of Pat Buchanan's new book is all in the subtitle: *How Neoconservatives Subverted the Reagan Revolution and Hijacked the Bush Presidency*. And in his usual full-metal-jacket style, Buchanan goes after what he describes as a cabal of former liberals out to impose a secular democracy on the world—especially the Islamic Middle East—safeguard Israel at all costs, and promote a benevolent American hegemony around the planet.

Tight in Buchanan's sights are all the usual neocon suspects. These include individuals such as William Kristol and publications such as *The National Review* and the editorial page of *The Wall Street Journal*. But it is Administration insiders, led by former Defense Policy Board Chairman Richard N. Perle and Deputy Defense Secretary Paul Wolfowitz, who come in for the heaviest of Buchanan's friendly fire. He charges that they took George W. Bush, "a *tabula rasa*" on foreign policy, and led him into a war they had plotted for a decade. Three years after September 11, Buchanan writes, the U.S. is "mired in a guerrilla war in a nation that had nothing to do with that terror attack."



Buchanan has never been a fan of the Bushes. In the New Hampshire primary of 1992, his shoestring campaign took 37% of the Republican vote and foreshadowed the vulnerability of George H.W. Bush. In 2000, as the Reform Party candidate for President, he mocked George W. as "a bellhop for Corporate America."

But Buchanan the pundit seems genuinely horrified by the Bush Doctrine: that we are in a war of good vs. evil; that the U.S. claims the right of preemptive strike against any regime seeking weapons of mass destruction; that Afghanistan and

A sermon lashing out at Bush's imperial folly

Iraq are the beginning of a world democratic revolution; that no nation will ever challenge the preeminence of the U.S. "This is democratic imperialism," he says. "This will bleed, bankrupt, and isolate this republic."

Buchanan makes the case that a war against terror is unwinnable because terror—however horrible—is a tactic, not a movement, and is often successful. It was used by the powerful against Dresden and Hiroshima, he writes, and most effectively by the weak, including the IRA against the British, the Zionists against the Brits and Arabs in Palestine, and the African National Congress against apartheid South Africa.

While he wants the terrorists of

September 11 hunted down, he rejects simplistic explanations of their motives. We were attacked, he maintains, because Arab and Islamic people resent U.S. domination, abhor America's bias toward Israel, and were incensed that thousands of our troops were defiling Saudi Arabia's "sacred soil." "The terrorists were over here because we were over there," he writes. "Terrorism is the price of empire."

Why listen to Buchanan, whose word sometimes sounds like a live feed from Chicken Little in a fallout shelter? Consider this: In 2000, he asked: "Will it take some cataclysmic atrocity on U.S. soil to awaken our global gamesmen to the going price of empire? America today faces a choice of destinies. We can choose to be peacemaker of the world, or its policeman who goes about night-sticking troublemakers until we, too, find ourselves in some bloody brawl we cannot handle."

Other than ramming through supersize tax cuts, Buchanan says, Bush is acting more like LBJ, running up massive deficits and running through other people's money with abandon. He calls a proposal to spend \$1.5 billion to promote marriage "God's pork."

Yet after scores of pages devoted to ranting about neoconservative creeps who have turned the Reagan Revolution into a failed movement, Buchanan concludes that alienated traditionalists must "come home" to Bush on Nov. 2. Two big reasons: The next President is likely to decide the composition of the Supreme Court for a generation, and traditional conservatives must cling to a place at the Republican table.

Still, it's painful to watch Preacher Buchanan throw logic to the wind, lay down his assault weapon, line up beside the apostates at the altar of Bushism, and genuflect before the golden calf.

—By **Ciro Scotti**

In Brief

A Lion in Winter

MEDIA MAN

Ted Turner's Improbable Empire

By Ken Auletta; Atlas Books/Norton; 205 pp; \$22.95

The media world is not nearly as much fun now that Ted Turner is no longer at center stage. The folksy, off-the-wall candor—which at times drove Turner's public-relations handlers to cardiac episodes—made his a refreshing voice. Beneath the outrageousness, though, one could always glimpse both the brilliance and the vulnerability.

Plenty has been written about the rise of Turner—the *bon vivant* with a Rhett Butler complex, the billboard salesman who revolutionized television by creating CNN, and, of course, the man who married Barbarella (a.k.a. Jane Fonda). But in *Media Man: Ted Turner's Improbable Empire*, Ken Auletta puts the most human of faces on Turner yet. The picture is of a tycoon who has lost his power—and maybe even his way—since being pushed off his pedestal in 2000 at what would soon be called AOL Time Warner.

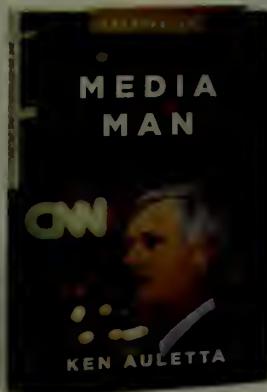
A staff writer for *The New Yorker*, Auletta is the dean of media journalists and has unsurpassed access to moguls. *Media Man* is an expanded and updated version of a 17,000-word *New Yorker* piece for which Auletta won a 2002 National Magazine Award. Here, Turner reveals his despair to Auletta, saying that during 2001 he felt suicidal. Compounding his woes at the time were two grandchildren's diagnoses with serious illnesses, his failed marriage to Fonda, and the temporary paralysis of his beloved black Labrador.

But at the center of this finely wrought portrait is Turner's shoddy treatment at the ill-fated AOL Time Warner, where he was first shut out of the merger talks and later stripped of his vice-chairman title. So upset was Turner that, during a National Press Club luncheon, he compared this abuse to a Third World genital-mutilation practice.

In addition to chronicling Turner's exile, Auletta also profiles a new Ted, driven by philanthropic interests, worry about the spread of nuclear weapons, and, yes, concerns about the power of Big Media.

All in all, *Media Man* is an astute look at a truly innovative executive who has seen more than his share of woes, large and small.

—By **Tom Lowry**



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Proactive



BY STEPHEN H. WILDSTROM

Those Superfast Chips: Too Darn Hot

Intel's recent announcement that it plans to produce new "dual-core" processors that amount to two Pentiums on a single chip drew attention mainly from hard-core techies. But it was an admission that the company's strategy for making PCs ever cheaper and faster has hit a wall: The chips are simply getting too hot. Further progress will require new technologies.

All chips generate heat that increases with speed. Keeping processors and other electronic innards cool has long been a challenge with laptops—simply because cramming everything into a slim box causes heat to build up fast, and there is little room for fans and cooling vents. But cooling today's fastest chips is becoming a challenge in even the biggest desktop towers. Unless someone finds a way to get more speed without overheating, we won't see the kind of chip performance that the next generation of software will demand.

Intel's top-of-the line processor, the 3.6-gigahertz Pentium 4 Extreme Edition, pumps out a maximum of 115 watts of heat. A high-end graphics card, memory chips, and a disk drive can easily add 100 watts or more. Think of a couple of 100-watt lightbulbs burning in a shoebox, and you get an idea of what the engineers are up against.

ONE INNOVATIVE APPROACH favored by gamers works like an automotive cooling system: A circulating fluid draws heat from the chips and dumps it through a radiator. But liquid cooling is far too expensive for mainstream desktops: The superfast Alienware Area-51 ALX, for example, starts at \$4,500. Better mechanical design can help in more conventional PC products, where thermal engineering has always been an afterthought. Computer makers, led by Gateway, are starting to migrate to a new Intel system design, called BTX, in which the PC is planned from the motherboard up to promote airflow for better cooling. Apple Computer also has done some brilliant engineering to air-cool its G5 desktop Power Macs and iMacs while keeping them very quiet.

Ultimately, though, the problem will have to be solved by reengineering the chips themselves. The main method for getting more performance out of processors is to cram more transistors onto chips and to run them at higher speeds. But the faster you run a processor, the more power it consumes,



and the more heat it throws off. Historically there have also been energy benefits as components shrink, because smaller devices require less power. But with the latest Pentium 4s, Intel hit diminishing returns on shrinking the components: The chips actually got hotter.

Ongoing changes in chipmaking technologies will help. In the longer run, however, dual-core processors are the best hope. IBM began using the approach in the Power micro-processors in servers back in 2001, and a version of that chip may be used in Macintoshes next year. Advanced Micro Devices announced dual-core plans earlier this year, and Intel says it will offer such chips in 2005.

Since new PCs already offer more speed than most consumers use, why does this matter to anyone but hardcore gamers, engineers, and the like? The answer is that software is demanding much more from hardware these days. Your word processor, Web browser, and e-mail program don't overburden the chip. But by now you also should be running antivirus software, an antispyware program, and a firewall (page 108)—all of which soak up computing power. Data encryption is very processor-intensive, too. And the next version of Windows will have a 3-D user interface that will put a huge strain on the hardware.

The upshot is that over the next few years we won't be seeing the kinds of gains in computing speed that everyone has grown accustomed to. Heat problems increasingly will impose speed limits. As for dual-core PC chips, these will probably be widely available by 2006—just in time for the "Longhorn" version of Windows to come along and scarf up all that extra processing power. ■

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BY ROBERT J. BARRO

Why Are the Dems Griping About Jobs?

I am struck during this Presidential race by how Senator John Kerry and his advisers are so obviously rooting for bad economic news. When the unemployment rate falls by a percentage point, as it has, it means that a lot of Americans are doing better economically. Perhaps Senator Kerry ought to pause a moment to be happy for these people before he reverts to his

familiar but unconvincing complaints about the Bush Administration's economic policies.

As the election nears, a fair assessment is that the economy is actually doing well. Gross domestic product has grown at more than 4% per year since early 2003, and investment and productivity have been strong. Inflation seemed to tick up for a while, but the consumer price index for the last two months has been tame. And after lagging, the labor market has seen a solid expansion of jobs in 2004. Since mid-2003 the unemployment rate has fallen by nearly a full percentage point, to 5.4%, below the average rate of 5.6% since 1948. This favorable picture is unlikely to change much before the election, because only two major reports remain—the September employment report on Oct. 8 and the third-quarter GDP report on Oct. 29.

Information about the labor market comes from two main sources, the payroll and household surveys. The payroll survey is good for assessing changes in employment. This survey indicates that 1.7 million net jobs have been created since the low point in August, 2003, but 0.9 million net jobs have been lost since the start of the Bush term in January, 2001. In the early part of the term, weak employment growth reflected the 2001 recession. The weak recovery in 2002 can be explained partly by the terrorist attacks of September 11.

THE LATEST PAYROLL REPORT FOR AUGUST was more favorable than generally recognized. Employment rose by over 200,000 when one factors in the upward revision for July. Some say that 150,000 to 200,000 new jobs are needed each month to keep up with labor-force growth. This estimate seems wrong, because the great expansion of labor-force participation from the 1960s through the 1990s, which was driven especially by women, has probably ended. It's reasonable to expect that the overall participation rate will now expand with population at 1% per year. Thus job creation of about 100,000 per month is sufficient to keep up with labor-force growth.

The other measure of labor market performance, the household survey, shows that for more than a year employment growth has surpassed labor-force growth. This is why the unemployment rate fell from 6.3% in June, 2003, to 5.4% today. The problem with the household survey is not

that the survey covers only 60,000 households, a number bigger than those used to measure electoral sentiment. The real difficulty is that we do not know the underlying population of households. This information arrives only every 10 years from the Census. Therefore, the household survey is unreliable for gauging month-to-month changes in employment and the labor force. Still, it is good for measuring the unemployment rate, which is the fraction of persons who want jobs but do not have them.

A one-month drop in the unemployment rate signals a stronger labor market even if the measured labor force declines in the month. In August, 2004, the unemployment rate fell from 5.5% to 5.4%, while the measured labor force fell by 152,000. By comparison, in May, 2004, the unemployment rate stayed at 5.6%, while the measured labor force expanded by 233,000. It is reasonable to infer that August was stronger than May.

The payroll survey also has deficiencies—failing to count the self-employed and workers at home and on farms. The household survey is better in these respects, and the month-to-month errors in measuring labor-force changes may not be so serious over longer

periods. Thus, it is significant that household employment increased by 1.9 million since January, 2001—2.8 million better than the payroll survey.

Traditionally, the unemployment rate has been accepted by Democrats and Republicans as one of the most important macroeconomic indicators. Thus it is disturbing that during this Presidential campaign, Democrats are trying hard to ignore the strength implied in the falling unemployment rate. If the rate were 11%, as in the worst of the 1982-83 recession, Democrats would be appropriately screaming. ■

Robert J. Barro is a professor of economics at Harvard University and a senior fellow of the Hoover Institution (rjbweek@harvard.edu)

BY JAMES C. COOPER & KATHLEEN MADIGAN

What's Everyone So Rattled About?

Despite record wealth, business and consumers remain wary of the future

U.S. ECONOMY Money can't buy happiness. And it doesn't seem to buy confidence, either. The latest data from the Federal Reserve show that U.S. households and corporations have seen their net worth levels rise to record highs, and both sectors are sitting on mountains of cash. Yet, uncertainty—whether about Iraq, the upcoming elections, or fuel

costs—is nipping at the economy's heels. Consumers are worried about job security and the future of gas and heating oil prices. Companies seem reluctant to commit to expansive hiring plans. And early warnings about profits have rattled the stock market. Even the weather is unsettled; hurricanes could skew the third-quarter data, especially on payrolls.

This persistent and widespread uncertainty is driving a wedge between the rapidly improving financial conditions of households and businesses and what those very strong balance sheets would typically imply for the outlook. Despite the economy's solid fundamentals, questions about the second half still loom.

Does that mean uncertainty could scuttle the recovery? Right now, that looks unlikely. First, despite their jitters, consumers are on track to increase their spending at an annual rate of about 3.5% in the third quarter. Second, companies may not be hiring in droves, but they are adding to their payrolls and going ahead with capital-spending projects. Business investment in new equipment accounted for more than a third of the growth in real gross domestic product in the second quarter.

Lastly, the Fed sounded a bit more upbeat about the economy after its Sept. 21 meeting than it did in August. As expected, policymakers hiked the federal funds rate by a quarter-point, to 1.75%. In its announcement, the Fed said the economy "appears to have regained some traction" and that labor markets have improved modestly, while inflation has eased. Some analysts had speculated that the Fed would signal a pause in its tightening process. But policymakers gave no such hint, suggesting another rate hike at the Nov. 10 meeting is likely.

BUT IT MAY TAKE MORE than the Fed's assurances to convince wary households and corporations. Keep in mind that uncertainty has been the hallmark of this recovery. Over the past three years, demand has been buffeted by a host of unknowns, from terrorism to corporate scandals to war. Luckily, the current run of uncertainty should begin to dissipate after the economy gets past two upcoming events: earnings season and the Presidential election. Once investors know the outlook for profits and who will occupy the White House, two

big clouds now hanging over the outlook will lift.

Uncertainty matters, of course, because it causes economic players to sit on the sidelines. In the past, Fed Chairman Alan Greenspan has compared uncertainty to walking into an unlit room. Faced with darkness, the occupant tends to freeze up. That may be happening again: Consumers and businesses seem to prefer to hold

on to their cash rather than spend it on goods and services or invest in the financial markets.

According to the Fed, households in the second quarter held a record \$5.5 trillion in such near-cash assets as checking deposits and money-market accounts. That's up \$233 billion from a year ago. Corporate cash flow dipped slightly from

HOUSEHOLD WEALTH: 'WE'RE IN THE MONEY'



Data: Federal Reserve, Global Insight Inc.

its record high of \$1.3 trillion in the first quarter, but it's up \$122 billion over the past year.

For consumers, total net worth hit a new high of \$45.9 trillion (chart). True, wealth is not evenly distributed among the population. According to the latest available data for 2001, the wealthiest 10% of households had a median net worth of \$1.3 million, while the bottom 25% had just \$1,000. Even so, the imbalance does not alter the economic rule that 3¢ to 5¢ of each dollar of sustained wealth will be spent, helping to boost overall demand.

The big wealth gains in the second quarter came from corporate equities and housing. Holdings of stocks and mutual funds were up \$1.4 trillion over the past year. However, it's interesting to note that equities as a share of financial assets have slipped from 35% in early 2000 to 27% today. Most of the wealth has shifted into liquid assets, as uncertain investors stay out of the markets.

ONE AREA where consumers feel no jitters is housing. Americans still see homeownership as one of the best investments around. Indeed, housing equity—total home values less mortgage outstanding—rose an additional

\$919 billion in the year ended in the second quarter.

Thanks in part to the recent fallback in mortgage rates, demand for homes remains solid. Housing starts in August edged up 0.6% to an annual rate of 2 million. And the National Association of Realtors is forecasting another record number of home sales for 2004.

Mortgage rates should stay reasonable because inflation is not the problem bond traders thought it would be. Remember that back in the spring, surging demand and the spike in oil prices caused consumer prices for all goods and services to jump at a 5.5% annual rate for the three months ended in May. Even excluding food and oil, core prices were rising at a 3.3% pace. That led to fears of a new inflation spiral and pushed up long yields. But in the three months ended in August, overall inflation was back down to 1.3%, and the core rate was 1%.

LOW INTEREST RATES also suggest that worries about consumer debt levels are overblown. Total household liabilities rose 9.3% in the year ended in the second quarter, with most of the jump coming in mortgage obligations. However, the value of households' real estate holdings has risen more than twice as fast as mortgage debt. Consumer credit, including credit-card and other revolving balances, is up only 4%.

Households' overall financing burden has actually declined over the past year. Since aftertax income is up about 6%, and since low rates over the past year induced many homeowners to refinance their mortgages, the amount of income needed to service household debt used

up 13.1% of income in the second quarter, down slightly from 13.24% a year ago.

For Corporate America, the situation is much the same as for consumers: lots of cash and manageable debt. The Fed data show that the net worth of nonfarm

GOOD CASH FLOW LIFTS CORPORATE WEALTH



nonfinancial corporations rose almost \$900 billion, to \$10.4 trillion in the second quarter (chart). Although assets rose 6%, businesses did not add much to their liabilities. But that trend may be changing. Commercial and industrial loans began to turn up this summer. That may indicate companies are shedding their caution. Another good sign is the rise in capital spending.

But beyond that, companies seem to be holding back. Businesses have not hired new workers or added to their inventories at the rates normally seen in an economy growing at a 4.5% yearly pace.

Instead, executives still seem stuck in Greenspan's metaphoric darkroom, waiting for the lights to be switched on. What the economy needs most are the conditions in which businesses and consumers feel more secure about making the investment and spending decisions that will drive this recovery into 2005. ■

BRITAIN

Rate Hikes May Take a Breather

WHILE THE U.S. has only begun to lift interest rates, and the euro zone hasn't even started, the Bank of England might well be finished.

After a series of five quarter-point hikes since last November, taking the target rate to 4.75%, the BOE's policy tightening appears to be having its desired effect: Britain's housing market is finally cooling off, and consumer spending is almost sure to ease back in tandem.

So a November rate hike, which had been widely expected to be the money managers' last in the series, may be off the table.

Mortgage lending plunged in July and remained sluggish in August, according to the British Bankers' Assn. Halifax Bank, Britain's biggest

mortgage lender, said house prices in August fell 0.6% from July, the first decline in two years. And based on a sampling from the property lister Rightmove, prices were essentially unchanged in the four weeks through mid-September.

By some estimates, the price runup has left homes up to 30% overvalued. Given strong labor markets and interest rates that are

not high by historical standards, a sharp decline in home prices seems unlikely. Nevertheless, with the sudden weakening in the housing market, the BOE said in the minutes of its September meeting that it "may have underestimated the potential for an associated

downward impact on consumption."

August retail sales rose, but they had plunged in July. And the August survey of retailers by the Confederation of British Industry showed a sharp weakening in activity. Economists at J.P. Morgan Chase & Co. estimate that, if monthly growth in home prices falls to slightly above zero in the coming 18 months, yearly growth in consumer spending will slow from 3.2% last quarter to 2% by the end of 2005. An outright drop in prices would hit even harder.

Coming on top of new questions about a global slowdown, and given that inflation is expected to stay well below 2% this year and next, new uncertainties over housing could put policy on hold for a long while. And unlike the Federal Reserve or the European Central Bank, the Bank of England has plenty of room to cut rates if Britain's housing bubble starts to lose air too fast. ■

RETAILERS REPORT WEAKER ACTIVITY





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BWK10/04

EXECUTIVE SUITE

CAN CHUCK PRINCE CLEAN UP CITI?

The aggressive culture he inherited from Sandy Weill is again hurting the reputation of the megabank

TRADERS ON CITIGROUP'S London bond desk were jubilant. On the morning of Aug. 2 they had just executed a daring coup: They dumped at least \$13.3 billion worth of European government bonds onto the market, then bought a third of them back at lower prices within about a half-hour—scooping profits that rivals say could be up to \$24 million. As Citi traders high-fived each other in triumph, pandemonium broke out in the market. Citi's actions weren't illegal, but broke an unwritten understanding not to whipsaw markets or take advantage of the thin summer trading. When a rival trader called to ask what was up, the Citi crew laughed and hung up.

No one is laughing now, least of all Charles O. "Chuck" Prince III. Since be-

coming Citigroup chief executive a year ago, he has been telling his 275,000 troops worldwide in a welter of visits and messages that he doesn't want any more bad publicity. In fact, he wants the world's biggest bank, with \$1.3 trillion in assets, off the front pages altogether. "We [won't] say we are never going to make a mistake, but we have a keen focus on not being in the headlines," he told money managers at a June 2 conference. "We're going to be judged on whether we meet that standard or not."

BANNED IN JAPAN

BY PRINCE'S own measure, he is failing. The bank is harvesting negative headlines galore and has regulators on its back on three continents. On Aug. 18, the British Financial Services Authority launched a formal investigation into the London

bond coup. And Citi—though it won't say who authorized the trades—apologized for what had happened and promised not to repeat the behavior. "This is exactly what Chuck Prince said wasn't going to happen," says Howard K. Mason, senior financial analyst with Sanford C. Bernstein & Co.

Within weeks, Citi was back in the news. On Sept. 17, Japanese authorities ordered it to shut down its local private bank by next September. Regulators said an investigation, begun in August 2001, had revealed extensive legal violations over seven years, including lax governance and money laundering controls and "numerous instances of unfair transactions...in which large profits were obtained through unsound means." Citi issued an apology, "with deep regret for its failure to comply with

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“We [won’t] say we are never going to make a mistake, but we have a keen focus on not being in the headlines. We’re going to be judged on whether we meet that standard or not”

CORNER OFFICE
Prince with then-
CEO Weill, who is
still chairman, in
July 2003

regulatory requirements," fired six bankers, slashed the salaries of eight other employees, and promised to improve its internal controls for all of Citi's operations in the country. Before the week was up, Japan's Finance Ministry banned Citi from participating in its government bond auctions.

Now *BusinessWeek* has learned that top Citi officials are among those the Securities & Exchange Commission and the National Association of Securities Dealers are investigating for failing to supervise analysts and investment bankers during the tech-stock boom—and thus prevent conflicts of interest that harmed investors. The investigation follows the April, 2003, \$1.4 billion global settlement between federal and state securities regulators and 10 Wall Street firms. Administrative charges could be brought within weeks, a source close to the matter says, but most likely before yearend. Citi declined to comment. Prince declined to be interviewed.

'CLAWS AND FANGS'

RULES AND regulations are one thing. Getting people to follow them is quite another. And as CEO, Prince seems unable to drive a sense of universal integrity very deep into the bank. Some critics wonder whether this is even possible. "Every time you turn around, there's some other embarrassing thing that has happened," says Kathleen Shanley, senior credit analyst at Gimme Credit Finance in Chicago. "It raises a question of whether Citi is reaching the limits of its growth." Adds Bernstein's Mason: "Citi has become so large that it is simply not possible to mandate behavior. The challenge now is to create a culture, to inculcate a shared set of values that guide employee behavior."

On occasion Prince sends mixed signals. He regularly jawbones staff about the need for higher ethical standards, but at other times he also seems to underestimate the full extent of Citi's problems. For example, in a Sept. 20 message to employees, he said no matter how tight the

bank's controls and how clearly the behavior in London and Tokyo deviates from its standards, "there will always be a small minority of people who will cross the line."

Prince's critics argue that the problems run deep and spring from the way Citi does business. "It's one of the most

standards and control continue to compromise Citi's image with customers and governments," says Moszkowski. In the worst case, they could stymie Prince's ambitions to build a much larger Citi empire abroad. Regulators may be less inclined to approve acquisitions or grant licenses. Corporate customers may be

reluctant to do business with it—and governments less eager to award it mandates to float billions in bond issues. "The constraint on Citi's growth is not its market size nor its capital," says Bernstein's Mason. "It may well be that Citi can't achieve its growth ambitions because it cannot safeguard itself properly from regulatory and reputation risk."

Bankers in London, for example, say that the modest profits from the Citi trading brouhaha were not worth the damage to its reputation. Apart from attracting the attention of the FSA, Citi has angered governments in countries such as Belgium and Italy that rely on the international bond markets—and often give Citi lucrative contracts to handle their deals. Why did the traders do it? "The Sollic spirit is still there," said one senior London banker, referring to the swashbuckling style of Salomon Brothers investment bank, which Citi bought in 1998. Regulators will no longer tolerate such behavior. Says Kathryn E. Dick, deputy controller for risk evaluation at the Office of the Comptroller of the Currency, a U.S. bank regulator: "[Banks] need to have an environment where people understand [that they can't] press the outer boundaries."

Prince, a lawyer by training, was drafted as CEO in part to draw—and enforce—such boundaries. Chairman and former CEO Sanford I. "Sandy" Weill handpicked him to guide the bank through rough legal and regulatory waters. Although Prince can be charming, he can also come across as abrasive.

In the wake of the analysts scandal and corporate blowups, Weill and Prince, who was then general counsel, took several measures mandated by enforcers



Bad News For Citi

A slew of controversies is keeping Citigroup in the headlines—just where CEO Prince doesn't want it to be:

- Regulators are mulling whether to charge top Citi officials with failure to supervise analysts and investment bankers. Action could come by yearend.
- The SEC and Justice are examining whether Citigroup Asset Management overcharged mutual-fund investors for record-keeping services.
- British authorities are investigating Citi's government bond desk in London. It sold at least \$13.3 billion of European debt in August then quickly bought back much of it at lower prices.
- Enron creditors are suing Citi, charging that it failed to say what it knew of the poor state of Enron's finances when it sold \$2.4 billion in Enron notes. Citi is fighting the suit.
- The SEC is looking at how Citi handled the accounting for its soured business in Argentina, where it wrote off \$2 billion in loans in 2002.

aggressive corporate cultures in banking, no doubt about it," says one Wall Street analyst. "These people grow up with claws and fangs." In a Sept. 20 report in which he downgraded the bank's shares to neutral from a buy, Merrill Lynch & Co. bank analyst Guy Moszkowski charged that Citi's "aggressive profit incentives [are] overriding judgment."

Those cultural flaws now risk damaging the bank, say critics. "Issues of ethical

They separated stock research from investment banking and eliminated interlocking directorships between Citigroup execs and companies affiliated with the bank's directors. And they created stricter rules on the kind of complex financing that it handled for Enron Corp. and WorldCom.

UNIVERSAL ETHICS CODE

NOW PRINCE has begun to overhaul the risk and compliance hierarchy in New York. He has given senior risk officer David C. Bushnell greater clout within the bank and ordered him to craft a set of compliance standards for the whole firm. Surprisingly, this didn't exist before. Also, audit committee members of Citi's board will get up to seven compliance reports a year compared with none before. A newly formed Policy Compliance Assessment Group will ensure new rules such as the separation of investment banking and research are enforced. And, starting in the fourth quarter, every Citi employee will receive ethics training. The bank's toll-free ethics hotline, in place for some time, will now be "aggressively marketed" to employees. Says Citi spokeswoman Leah C. Johnson: "This is the way that Chuck believes that you embed the change in the culture."

Although Prince has been grappling with one public relations nightmare after another, his tenure so far has been a financial success: The bank reported two record quarters, with profits reaching \$5.27 billion in the first quarter this year. The growth culture he inherited from Weill evidently still lives on. Now Prince somehow has to temper the energy that drives Citi's culture without snuffing it out. He has pumped up his message to employees in recent weeks, and the bank's spokeswoman says he'll be attending more town hall meetings worldwide along with reviewing how he pays his bankers. "We have to have the moral compass to deliver those profits and growth responsibly and honestly," he said in his Sept. 20 message to staff. "Citigroup's culture must be synonymous with integrity."

Beyond fine words, Prince has to transplant that culture of probity into the DNA of thousands of employees worldwide. The faster he does so, the less the bank's dealings will be the stuff of headlines. ■

—By Mara Der Hovanesian in New York, Paula Dwyer in Washington, and Stanley Reed in London

COMMENTARY

BY RICH MILLER AND PETER COY

Falling Bond Yields: Not To Worry

They reflect investors' ebbing fears about inflation



BOND BONANZA

Late-year buys are pushing prices up

cern. It mainly reflects ebbing inflation fears and growing investor confidence in the Fed's determination to keep price pressures in check, rather than worries about weakening gross domestic product growth.

That bodes well for the economy. As long as investors are convinced

WHAT'S UP with the bond market? As the Federal Reserve has steadily increased short-term interest rates over the past few months, investors in the bond-trading pits have pushed long-term yields down. Indeed, the yield on the Treasury's 10-year note eased to 3.98% on Sept. 22, its lowest point in nearly six months, a day after the Fed bumped up short rates another quarter percentage point.

For the doom-and-gloomers, the answer to the bond market's seemingly perverse behavior is simple: Fears are growing that the economy is in for weaker growth than Fed Chairman Alan Greenspan and his colleagues think. "The market is skeptical of the Fed's forecast of a robust rebound," says Craig Coats, executive vice-president at investment bank Keefe, Bruyette & Woods Inc.

But wait a minute. Despite the naysayers' claims, the fall in bond yields is more a cause for comfort than con-

that inflation will stay low, the Fed can afford to take its time raising rates to more normal levels, giving the economy time to adjust.

Look at the numbers. After rising at an annualized 5.1% in the first five months of 2004, consumer price inflation slowed dramatically over the summer, to a mere 1.3%. Not surprisingly, bond yields fell in response. In fact, the 10-year Treasury note yield hit its high for the year, 4.87%, on June 14, the day before the Labor Dept. reported a dip in underlying inflation, and has been falling ever since.

End of a Scare

INFLATION EXPECTATIONS have also eased, dragging bond yields down with them. Judging by the Treasury's inflation-protected securities market, investors expect inflation to average about 2.3% per year over the next 10 years. That's down from a 2.8% rate expected in the spring, at the height of the market's inflation scare. The implication: More than half of the drop in yields can be attributed to changing inflation expectations.

What's behind the pullback in infla-

tion? The twin factors of competition and productivity. While productivity growth has fallen from its stratospheric levels of 2003, it is still on track to grow about 4% this year. That pace enables companies to hold the line on prices without seeing their profits get whacked. In fact, Standard & Poor's says that operating earnings of the S&P 500 rose 31% in the second quarter from a year earlier and are on track to rise 15% in the third quarter.

Investor Calm

IT'S NO WONDER, then, that the stock market has been on the rise since early August. Although share prices slumped on Sept. 22 after oil prices jumped and FedEx Corp. warned that profits would fall short of expectations, key market indices are still trading near two-month highs. That suggests stock investors, at least, don't share the concerns of the economic worrywarts. "I don't think the economy is tanking, and I don't think the market thinks so either," says Nariman Behravesh, chief economist at consultants Global Insight Inc.

The story is much the same in the corporate bond market. If investors thought the economy was about to stall, they'd demand a bigger premium for corporate bonds vs. Treasuries to compensate for the extra risk of holding those securities. That hasn't happened. Instead, the yield spread between corporate bonds and Treasury securities has held steady as the debt market as a whole has rallied.

Part of that rally, especially recently, has been inspired by a short squeeze on bond market bears rather than by a change in the economic outlook. Many investment managers shied away from bonds early in the year, convinced that yields would rise as the Fed hiked short-term rates. Now, with the end of the year in sight, they're finding that they have to reenter the market to buy bonds in order to recalibrate their portfolios. Such buying is pushing prices up and yields down.

It's not always easy to parse bond-market behavior. There are millions of investors in the market. Undoubtedly, some of them are purchasing bonds because they're worried about the economic outlook. But the bulk of the buying so far has been for more benign reasons. The low interest rates it has brought should be welcomed, not dreaded. ■



ENERGY

A THORN IN HALLIBURTON'S SIDE

Its Kellogg Brown & Root unit is hurting the stock. Is a parting of the ways likely?

CHIEF EXECUTIVE David J. Lesar might be right when he describes Halliburton Co. as "the most scrutinized company in the world." The \$20 billion Houston giant has taken a public beating in the past couple of years over allegations that its Kellogg Brown & Root (KBR) engineering subsidiary overcharged the government on Iraq contracts and that some KBR executives bribed Nigerian officials, as well as for costly ongoing asbestos litigation. But in the eyes of some investors, the most damning thing about KBR is that it doesn't make any money.

For that reason, investors and analysts are betting that Halliburton will dump KBR within six months to a year. The unit is a poor fit with Halliburton's successful oil-services business, they say, and its weak performance explains why Halliburton trades at a significant dis-

count to its peers. Says energy analyst Jason E. Putman at Victory Capital Management Inc., which holds some 2.3 million Halliburton shares: "KBR has become an albatross for them."

SYNERGY SHORTAGE

THE 51-YEAR-OLD Lesar, who took the reins at Halliburton when Dick Cheney stepped down to run for Vice-President in 2000, is being tight-lipped about KBR's fate. He was expected to address the issue at a Sept. 23 investor and analyst meeting, but some investors say that in private conversations Lesar has already admitted that he sees few synergies between Halliburton's oil-services business and KBR, its engineering and construction unit. Lesar says that while the question has been posed to him in conversations with investors, he does not recall having such one-on-one chats. Through e-mail, he said: "After KBR emerges from bankruptcy and we resolve

the asbestos issue, we will take a look at our entire business portfolio."

To many observers, shedding KBR should be a no-brainer. Its problems began long before the Iraq contracts made Halliburton a target of Bush Administration critics. KBR inherited the asbestos mess back in 1998, when Cheney bought Dresser Industries Inc. (page 121) As lawsuits piled up, KBR was forced to file a prepackaged bankruptcy last December. In July, Halliburton won court approval of its \$4.2 billion asbestos settlement plan. The company now expects to emerge from reorganization in the fourth quarter with the asbestos headache

gone. Meanwhile, though, charges related to the litigation and losses on a huge project in Brazil led to a \$292 million operating loss for KBR in the first half, on revenues of \$6.8 billion. That comes on top of a full-year 2003 loss of \$36 million, on revenues of \$9.3 billion.

For all the headlines they've generated, many of KBR's \$23 billion of government contracts only barely turn a profit. For instance, in the second quarter, KBR eked out an operating margin of 1.4% on its \$1.7 billion of Iraq-related work. All told, KBR now has \$11 billion of Iraq contracts. Margins are expected to fall even further in the near term, as a large oil field construction contract ends and work on smaller, less profitable job begins. The work in Iraq has turned out to be far more complex, and dangerous, than the company envisioned. If KBR decides to bid for other contracts there, it will likely "jack the margins up significantly," Lesar said at a Lehman Brothers Inc. conference in New York on Sept. 7.

Nevertheless, KBR remains under fire for charges that it has inflated its Iraq billing. The company has powerful enemies in Congress, including outspoken Representative Henry A. Waxman (D-Calif.), who has attacked Halliburton and its missteps in Iraq as "overcharging the taxpayers." Halliburton denies the allegations and, in fact, on Sept. 7 the Pentagon's Defense Contract Management Agency (DCMA) said KBR's purchasing policies and practices are "effective and efficient." Yet the Pentagon may still withhold 15% of future payments, amounting to about \$60 million a

month, on a troop support contract until Halliburton provides details to back about \$1.8 billion of work already completed. Lesar says that if that happens, the impact on KBR will be mitigated because it will withhold payments from its subcontractors. The Army is also now considering breaking up its multibillion-dollar logistics contract in Iraq among several players. Halliburton says that it has anticipated that possibility, although it may still bail out altogether if too many bidders vie for the work.

"LESS THAN ZERO"

THE MESS AT KBR stands in stark contrast to Halliburton's oil-services business. Thanks to stubbornly high oil and gas prices, it is hitting on all cylinders,



KBR'S KEEPER
Halliburton
CEO Lesar

Under The Gun

Troubled by government contract investigations, asbestos litigation expenses, and cost overruns, Halliburton's KBR unit has struggled with red ink.

OPERATING LOSSES (IN MILLIONS)

2002 \$685

2003 36

2004 (Est.) 197

Data: Company reports. Friedman, Billings, Ramsey & Co. Inc.

making drill bits, testing wells, and providing software to help oil companies improve their drilling odds. Indeed, while the Energy Services Group (ESG) accounted for only 43% of Halliburton's revenue last year, it pitched in all of the company's \$720 million operating profit.

Investors believe that KBR's subpar performance is the major reason Halliburton's stock trades at a 20% to 25% discount to other big oil-services outfits such as Schlumberger Ltd., the industry leader, and Baker Hughes Inc. Those companies have price-to-estimated 2005 earnings

ratios in the mid-twenties, vs. Halliburton's forward p-e of 19.7. Analyst Robert F. Mackenzie of Friedman, Billings, Ramsey & Co. figures that Halliburton, the No. 2 oil-services player, should be trading at around \$40 a share. He estimates that ESG alone is worth \$34.50 and a stand-alone KBR would be worth about \$2.5 billion to \$3 billion, or \$5 to \$6 a share. Yet Halliburton trades around \$32. To Mackenzie that implies that "KBR is [currently] worth less than zero."

For the time being, Lesar has promoted Andrew R. Lane, a 22-year veteran of Halliburton's oil-services business, to fix KBR's problems. Lane, who is 45, is expected to place bigger bets in the emerging liquefied natural gas (LNG) market—the business of designing and building plants that liquefy natural gas for shipment and reconvert it at the receiving end. LNG is one of KBR's few bright spots; it is the worldwide leader in building the processing facilities, which are in high demand. KBR has built more than half of the existing plants worldwide over the past 30 years.

KBR also is shifting away from big fixed-cost offshore construction contracts, to contracts where costs can be reimbursed. Such fixed-cost work as the \$2.5 billion Barracuda-Caratinga project, which involves converting two supertankers off the coast of Brazil into floating oil production, storage, and offloading vessels, has racked up losses of \$762 million over the past three years because of building delays and cost overruns. Says Lesar: "In this business if you have just a few projects with problems it can consume the overall profit margins, and that's what we've seen happen recently."

Analysts say KBR is almost certainly worth more to another engineering outfit than if it was spun off to Halliburton shareholders. "Somebody may buy [KBR] just to get access to its LNG business," says analyst Robert S. Goodof of Loomis Sayles & Co., which owns about 1.5 million Halliburton shares. Prospective buyers could include large engineering competitors such as Fluor and Bechtel Group. Both declined to comment on any potential interest in KBR.

As KBR winds down its work in Iraq, begins using less risky cost-reimbursable contracts for its offshore business, and grows its LNG operations, the troubled unit may crawl back into the black. But the likelihood is growing that by the time KBR gets straightened out, it will no longer be flying the Halliburton flag. ■

—By Stephanie Anderson Forest in Dallas,
with Stan Crock in Washington

COMMENTARY

BY KATHLEEN KERWIN

The Care and Feeding of Jaguar

Big missteps have tarnished the marque, which now clouds Ford's outlook

JAGUAR IS BILL FORD'S RECURRING nightmare. For 15 years, Ford Motor Co. has owned the British luxury marque, and each time it seems to turn the corner, Jaguar Cars Ltd. starts bleeding red ink again. On Sept. 17, Ford unveiled yet another rescue plan, announcing that it will shutter an aging factory in Coventry to reduce excess capacity and cut costs.

Each setback pushes CEO Ford's ambitious goals for the company's European brands further out of reach. In early 2002, he vowed that Ford's Premier Automotive Group—which includes Land Rover, Volvo, Aston Martin, and Jaguar—would contribute nearly a third of pretax profits by 2006. While Ford is sticking to that target, the problems at Jag dragged PAG down to a \$342 million operating loss in the first half. If Ford can't turn Jag around, meeting Bill Ford's vow to rake in \$7 billion in pretax profits by mid-decade will be tough.

So why has Ford failed to turn its top-shelf brand into a consistent moneymaker? Factory efficiency and quality are much improved at Jaguar. But there have been some epic stumbles, not least the rollout of the X-Type compact, a poorly executed entry-level luxury car known as the Baby Jag that turned off Jag loyalists. Add in an overly ambitious expansion, stale styling, and one-size-fits-all marketing, and it's easy to see why Jag had to discount heavily to hit its global sales target of 125,000 in '04.

Solving these problems will be hard, but not impossible. Here's a blueprint for giving Jaguar back its growl:

IT'S THE CARS, STUPID Job One may be a replacement for the X-Type. There's nothing wrong with rolling out starter luxury wheels; BMW and Mercedes did good jobs with their 3 Series and C-Class cars. But Ford made a huge mistake basing the X-Type on the mass market Ford Mondeo, which cheapened the brand. Borrowing a better chassis from Volvo would be a good start. To correct the first car's failings, the new model needs plenty of horsepower, silky handling, and an interior that isn't

cheesy. "If they spent another 200 bucks on the interior, they could get some results," says a Ford insider.

LOOKS REALLY DO COUNT Jag needs more than engineering fixes. Its design studio has to style cars with the sinuous, feline grace that defines the brand, while making sure new offerings look fresh. Sales of the revamped XJ, Jag's flagship model, are suffering because it looked too much like the old one; buyers who shell out \$70,000 want everyone to see that they have a new Jag. That could be fixed with a quick overhaul of the exterior design. Ford design chief J Mays says next year's completely redesigned XK sports car will be a "forward-looking" car that "will radically change Jaguar's image." Bring it on.

GET A MESSAGE Ford bungled Jag's marketing by adopting a mass-market approach for the luxury-niche brand—and then changed the strategy as frequently as though it were engine oil. Jag needs consistent positioning as enduring as BMW's three-decade-old "Ultimate Driving Machine." Jag also uses the same pitch worldwide—never mind that its distinct "Britishness" plays differently in Peoria than it does in Piccadilly. Worse, the current slogan, "Born To Perform," extols horsepower not looks, even though style is the main reason owners cite for buying a Jag. Ford ought to dash the current strategy

and hire a small, talented agency that will nurture the brand's leaping cat icon, helping it segue in the U.S. from Avengers-style panache to the generation personified by Brit actor Jude Law.

RUBBISH THE REBATES Better products and an appealing marketing strategy should help Jaguar cut back on the cheap sale gimmicks that have tarnished its image. Jaguar CEO Jo Greenwell says he'll reduce heavy rental car sales and hard-sell deals. It's time: U.S. incentives neared \$5,000 per car in August vs. \$464 at Lexus and \$552 at Mercedes, according to auto data Web site Edmunds.com. And the only luxury brand with lower resale values is Jag's PAG stablemate, Land Rover.

Ultimately, Ford needs to get real. Even Mark Fields, head of PAG and Ford of Europe, says that "a quick turnaround is unlikely." If demand still doesn't match Jag's reduced output by next year, more painful factory cuts may be needed. Jaguar is a venerable brand that survived decades of antique factories and quality so bad it was the butt of jokes. It would be a shame if the British cat ended up as road kill. ■

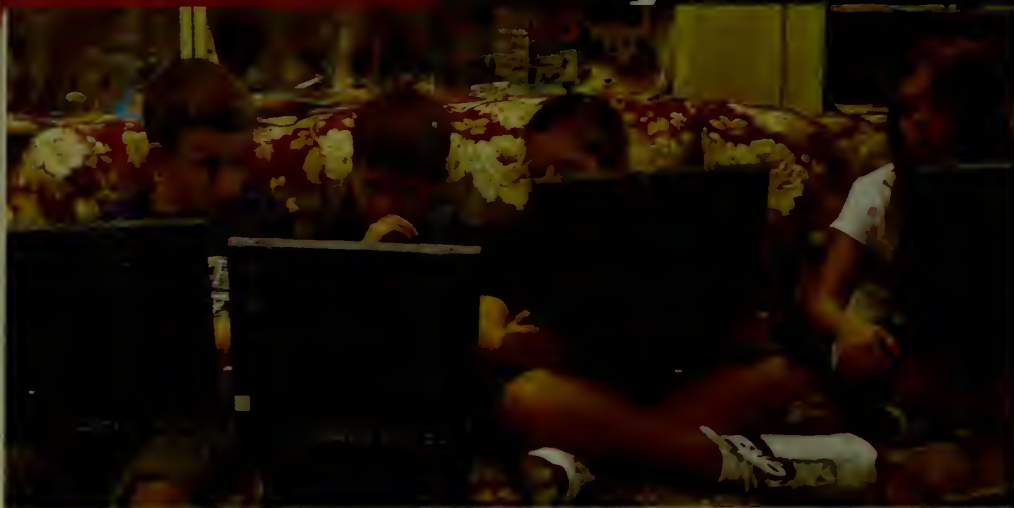
—With David Kiley in New York



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WIRELESS

WELCOME TO BROADBAND CITY

Towns are rushing to build Wi-Fi systems. Cable and phone giants don't like it one bit

FOR TWO DECADES, ALLEGANY County in western Maryland has seen its glass, textile, and tire industries wither—one reason the depressed rural community of 80,000 wants to attract high-tech employers. But spotty high-speed Internet service from phone and cable companies has been an obstacle. Luckily, the county has already connected its government offices, schools, and police force with a fast wireless network. Now, by spending \$4.7 million on upgrades, it will offer homes and businesses speedy links by yearend. “You’ve got to have this technology to run a business today,” says Douglas S. Schwab, chief operating officer of Cumberland (Md.) clothing maker S. Schwab Co., which uses Web connections to track inventory.

Allegany County isn't alone. New technologies—which extend the range of wireless broadband from Wi-Fi's cafe scale to metro-size—can cost a fraction of what competing cable and phone systems must pay to dig up streets and upgrade lines. By sending signals over the airwaves from inexpensive antennas mounted on light poles, small-town mayors and local entrepreneurs around the country are already providing low-

cost broadband. Now large cities are getting into the act. Corpus Christi and Houston are moving forward on Wi-Fi networks, as is Philadelphia, which recently announced plans to build its own \$10 million Wi-Fi network. By next year the city hopes to offer free or cheap broadband access to its 1.5 million residents. “We want everyone to have an equal opportunity to compete in this digital age,” says Dianah Neff, the city's chief information officer.

Not surprisingly, cable and telcos aren't happy about their new rivals. The muni wireless network is an unexpected twist in what had been a two-way race to sign up broadband subscribers. By creating “a third pipeline,” muni networks should lower prices and speed the spread of broadband, says Michael Calabrese, vice-president at the New America Foundation, a Washington think tank.

Phone and cable companies are lobbying hard to halt the trend. So far, 13 states have restricted

CUMBERLAND, MD.: Schools are already connected

towns from offering broadband. “It's better for all involved if private companies are using risk capital and not

taxpayer money” to provide broadband says Link Hoewing, vice-president for Internet policy at Verizon Communication Inc. But while the broadband giants fight to protect their hefty investments in copper and fiber—and head off price wars—the may ultimately be forced to adopt the new technology if it takes off. Verizon today offers wireless service in rural Grundy, Va.

STARTUPS RUSH IN

CERTAINLY, THE ECONOMICS of Wi-Fi are compelling. Some wireless system cost as little as \$30 to connect each home compared with the \$60 to \$80 it can cost a cable or telecom company. That makes wireless attractive for rural towns looking to stoke economic development and cities seeking affordable Web access for low-income citizens and government employees. At least two dozen communities have started their own networks by June, and the rate of launches is on the rise, according to MuniWireless.com, a Web site.

Entrepreneurs are taking note. Some 2,000 of them are selling fast wireless links to communities, most of them rural across the country. And in June wireless phone mogul Craig McCaw launched Clearwire Corp. in Kirkland, Wash., to sell high-speed wireless services in cities such as Jacksonville, Fla. Unlike many municipal networks, Clearwire will use exclusive licensed spectrum to reduce interference and boost reliability.

Will wireless wind up being the Holy Grail of broadband? Probably not. The new technology still needs to prove its re-

liability over long distances. The best broadband will eventually come via fiber, which can transmit data 100 times faster than today's wireless systems. That will enable video as well as voice and data services.

Yet for now, fiber's cost at around \$2,000 per home, poses a huge hurdle. So wireless networks will be sticking around. And that's likely to give the big cable and telecom providers one more thing to worry about. ■

—By Catherine Yang in Washington and Heather Green in New York

THE STAT

\$30

PER HOUSEHOLD

Approximate cost of building urban Wi-Fi broadband networks. Cable and telecom outfits can spend \$60 to \$80 to provide wired broadband.

Data:



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COMMENTARY

BY STEVE HAMM

Is Outsourcing on the Outs?

Not really, but companies are taking a closer look at whether it's worth it

THE ANNOUNCEMENT sent ripples of anxiety through the tech world. On Sept. 15, J.P. Morgan Chase & Co. said that it was terminating a seven-year, \$5 billion technology-outsourcing deal with IBM. For many, it's an article of faith that corporations will gradually hand off ever more of their technology operations to big service providers such as IBM, Accenture,

and Electronic Data Systems. Yet here was the nation's second-largest bank taking its tech back because it was strategically too important to be left to an outsider. Is outsourcing losing its steam?

The short answer is no. Most analysts and IT services companies say the J.P. Morgan move doesn't presage a major shift in the market. Still, many businesses are taking a harder look at how they handle their IT. To ensure they're getting bang for the buck, chief information officers are exerting more control over what they outsource, dividing the contracts among vendors according to specialty and, like J.P. Morgan, even ending contracts and bringing tech operations in-house. As a result, industry watchers see fewer multibillion-dollar deals and more pressure on tech-service companies' profits. "This is a wake-up call" for the industry, says Gartner Research analyst Susan Cournoyer. "Don't take outsourcing for granted."

The issue boils down to how much of a company's IT should be outsourced. If you're J.P. Morgan, the answer is: almost none of it. When Morgan acquired Bank One Corp. in June it inherited the Chicago lender's \$1 billion worth of state-of-the-art technology investments made over the past three years. Austin A. Adams, the former Bank One chief information officer who has moved over to that job at Morgan, con-

siders technology strategic since it boosts reliability and efficiency—crucial to improving service. "Having the majority of the work performed by employees gives us the best shot at technology being a competitive advantage," he says.

Even for companies that are still true believers in outsourcing, control has become the issue. General Motors Corp. has radically changed how it deals with its former subsidiary, EDS, which once handled most of GM's IT needs. Ralph Szygenda, GM's CIO, has 2,000 techies who craft overall strategy, select technologies, and manage EDS's managers. And to reduce his

NO PLACE LIKE HOME
GM is centralizing its info-tech needs

reliance on EDS, he has handed off about a third of GM's outsourcing to other contractors.

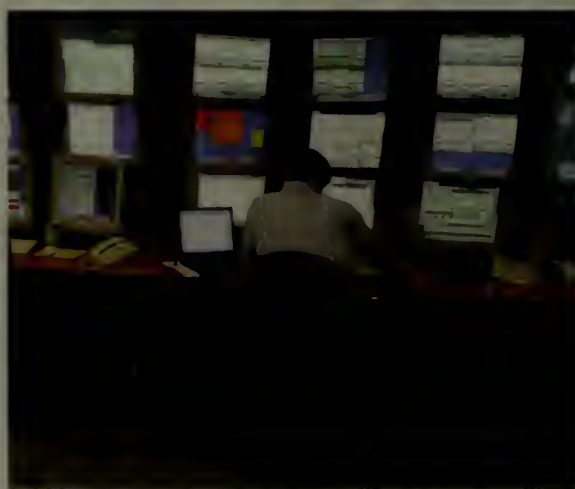
Now Szygenda is embarking on what he calls GM's third generation of outsourcing. He's getting 13 top tech services providers to adopt the same processes for running computers, software, and networks. So when something goes wrong with a computer, there's one way of responding—not 13. "It's a brave new world," says Szygenda. "It takes a lot of management to make it work."

Companies don't need to have the heft of GM to exert more control over their service suppliers. Since the tech slowdown, businesses commonly reopen contracts and renegotiate terms. Most of the newer deals have incentive clauses. If service providers

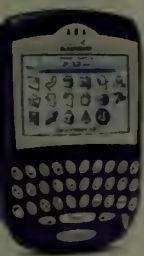
don't meet goals for improvements in operations, they don't get paid. As part of a February, 2004, deal to provide Sprint's customer-management services, for example, IBM is required to meet goals for the rate at which complaints are resolved in the first phone call, the customer churn rate, and even Sprint's customer-service rankings by J.D. Power & Associates.

But if companies are demanding greater control and transparency, by and large they are sticking with outsourcing. Of the thousands of companies that have off-loaded tech operations only 3% later took them back, according to a 2003 Gartner survey. And some who did aren't too proud to change their minds. Take Farmers Group Inc. In 2000, the Los Angeles insurer grabbed back maintenance of its mainframes. While it's still keeping that job in house, Farmers handed its insurance-management applications to Computer Sciences Corp. in July.

It may be years before it becomes clear how much benefit companies get from outsourcing. In the meantime, expect a lot of trial and error. ■



Even for the true believers, control has become an issue



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CALIFORNIA

CAN ARNIE PUMP UP BUSINESS?

Schwarzenegger is backing a slew of initiatives to help the state compete

IT DOESN'T TAKE MUCH TO GET California Governor Arnold Schwarzenegger to flex his muscles. But on Sept. 20 he did it from the back of a moving van emblazoned with "Arnold's Moving Co."—a perfect photo op as the onetime action star hauled boxes to help tiny Lynch Sign Co. move 14 employees from Las Vegas to the Los Angeles suburb of Laverne. "We love it when we take jobs from Las Vegas," Schwarzenegger crowed. "And from Arizona, and from New Mexico, and all those places."

With the zeal of a star on opening night, the 57-year-old Schwarzenegger is remaking California at a remarkable pace. His first 100 days were a blizzard of backroom deals culminating in pacts to cut the budget, refinance the state's towering \$15 billion debt, and rein in the sky-rocketing cost of workers' compensation insurance. Now he's embarking on the second act of an ambitious plan to make the Golden State more business-friendly.

Since the legislature adjourned in August, the governor has been busy terminating laws that counter his pro-biz agenda. He has vetoed bills to raise the state's minimum wage and make it harder for huge retailers such as Wal-Mart Stores Inc. to build nonunion superstores. He is also expected to reject a bill banning

state agencies from sending jobs overseas and to veto another that would allow low-priced pharmaceuticals to be imported from Canada—a big issue for the state's biotech industry. Critics deride the moves as window dressing, but the business community is applauding. "We're giving him an A-plus," says state Chamber of Commerce President Allan Zarembek, whose organization has lent at least two of its top execs to Arnold's executive team.

And the big guy is just getting started. As voters rev up for the November election, Schwarzenegger aims to put down his veto pen and take to the stump. He wants to elect more Republicans to the Democrat-heavy Assembly. He's also getting involved in a pair of ballot initiatives that address two of business' biggest con-

LAS VEGAS The Guv takes to the road to lobby out-of-state companies to move

cerns: runaway lawsuits and sky-rocketing medical insurance.

Schwarzenegger is supporting Prop. 64, which would overturn provisions of a law that lets private attorneys sue companies for deceptive advertising or for breaking safety or consumer laws, even if the plaintiff can't prove harm. And he opposes Prop. 72, which would require companies with 50 or more employees to provide health insurance—opponents say it would cost \$7 billion by 2007. Organized labor aims to fight the governor on both issues. "He's kicking the California worker in the gut," says Art Pulaski, executive secretary-treasurer of the California Labor Federation.

Victory on these fronts would help Schwarzenegger show that California is turning the corner—but he has a long way to go. Electricity rates and unemployment costs remain high, while roads and ports are in dire need of repair, notes Jack M. Stewart, president of the California Manufacturers & Technology Assn. Despite recent ratings hikes by three agencies, the state's bond ratings remain among the lowest in the nation. Good manufacturing jobs continue to vanish, replaced by lower-paying service jobs that are projected to grow 0.8% this year and 2% next year—both below the national average. "At least the lights are on, and someone's home," says Stephen Levy, director of nonpartisan think tank the Center for Continuing Study of the California Economy. "But Schwarzenegger has to deal with a lot of structural issues."

And he could get distracted fighting two ballot initiatives that threaten to undermine the state's recently patched-up finances. Back in June, he struck a deal under which five Indian-owned casinos get exclusive rights to run slot machines in the state in exchange for paying \$1 billion in taxes a year and more in the future—crucial to help close the budget deficit. One initiative would raise the 15% tax rate

Schwarzenegger negotiated with the tribes and could let racetracks have slots; the other would cut the tax to 8.84%. Both are backed by heavy hitters with deep pockets, forcing the Guv to raise hefty amounts of cash and test his 65% popularity rating on the stump. It ain't hauling boxes for photo ops but it will take muscle. ■

—By Ronald Groves
in Los Angeles

Arnold's Next Act

PAY The governor's veto of a hike in minimum wages could save business some \$2 billion a year

HEALTH CARE He backs repeal of legislation requiring most employers to provide health insurance

TORT REFORM A state law allowing lawsuits, even if plaintiffs weren't injured, is also in his sights

LABOR Schwarzenegger has vetoed legislation making it tougher to build nonunionized mega-retailers

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—Money® magazine, 2/04

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Lipper Equity Income Funds Average	18.27%	1.56%	10.29%	1.59%
Equity Index 500 Fund	18.73%	-2.46%	11.52%	0.35%
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News In Biz This Week

EDITED BY MONICA ROMAN

HEADLINER

STEVE HEYER



TWO'S A CROWD

After being passed over for the top job at Coca-Cola, Steven Hoyer is checking into **Starwood Hotels & Resorts**. Hoyer, 52, will take over from founder Barry Sternlicht as chief executive on Oct. 1. He is likely to push for further extensions of the hotel brands into retailing, spas, golf courses, residences, and other businesses. But first, he will have to learn to work with Sternlicht, who is sticking around as executive chairman and chief design officer—in a bow to his passion for ideas ranging from the **Westin's** Heavenly Bed to the **Sheraton's** shampoo bottles. Among other things, Sternlicht says he was attracted to Hoyer's reputation as a marketer and an innovator. Prior to joining Coke, Hoyer was president of **Turner Broadcasting System**, where he helped to launch 14 new TV networks and 19 Web sites. With business on the upswing at Starwood, he will have the wind at his back for a while. But nurturing the house that Barry built while the former boss is still around could prove to be one of Hoyer's biggest challenges yet.

—Diane Brady

SETTLING THE SCORE AT CA

Computer Associates International seems to be putting its accounting problems behind it, but for former CEO Sanjay Kumar the hard part is just starting. On Sept. 22, the Justice Dept. announced a settlement with CA, while the Securities & Exchange Commission charged Kumar with securities fraud. The Justice agreement ends a two-year probe into allegations that the company improperly recognized revenues. Under the agreement, CA will pay \$225 million into a fund for shareholders. Justice agreed to defer prosecution of CA on criminal charges, instead putting the company on probation for 18 months. Kumar could not be reached for comment, but in the past he has denied any wrongdoing.

KODAK'S BRIGHTER DAY



Eastman Kodak's painful transition to digital photography is bearing fruit. On Sept. 22, Kodak told investors it expects digital sales to grow at a compound annual growth rate of 36% between 2003 and 2007, substantially faster than its earlier forecast of 26%

growth. To be sure, the traditional film business is fading fast. But by next year, Kodak expects that over half its sales will come from digital. As a result, it now expects total sales to grow at a 7% to 8% clip over the four-year period.

FLUMMERY FROM FANNIE?

First **Freddie Mac**, now **Fannie Mae**. Federal regulators on Sept. 22 released a report that casts a dark cloud over Fannie Mae, the larger of the housing finance giants with \$1 trillion in assets. The Office of Federal Housing Enterprise Oversight says Fannie massaged accounts to meet earnings estimates and in 1998 may have deferred \$200 million in expenses so its execs, including Chairman Franklin Raines, could get bonuses totaling \$4.8 million (page 78). OFHEO cast doubt on Fannie's 2001-03 earnings, which may have been overstated. If so, Fannie's capital levels may have been understated—raising safety questions. The SEC has begun an inquiry to see if a restatement is needed, and Fannie's board hired former Senator Warren Rudman to advise a panel of outside directors overseeing the matter. A Fannie spokeswoman said the company declined to comment.

NONSTOP VIDEO ACTION

For **Sony** and **Nintendo**, there's no letup in the console wars. Nintendo's new dual-screen Game Boy Advance handheld will hit U.S. stores on Nov. 21 at an aggressively priced \$149. Not to be outdone, Sony will sell a redesigned PlayStation 2 console that is

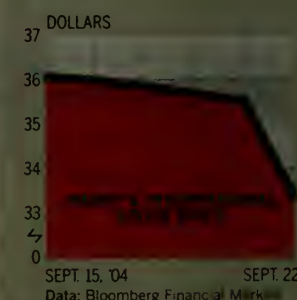
half the current size, with the price remaining at \$149. Sony's move is aimed at tempering a decision to launch its new PlayStation Portable, or PSP, handheld only in Japan this holiday season. Nintendo hopes to sell 4 million units by March, before PSP, hits the U.S.

ET CETERA...

- » **AIG** said the SEC may bring civil action against it for allegedly helping **PNC Financial** hide bad loans.
- » The FCC fined **Viacom's CBS** \$550,000 for Janet Jackson's breast-baring Super Bowl halftime show.
- » **General Motors** plans a late-month sales blitz with six-year, 0% loans.

CLOSING BELL

Charley, Frances, and Ivan have been beating up Wendy. On Sept. 22, burger chain **Wendy's International** warned that the hurricanes, along with higher beef prices, have hurt third-quarter profits. The news sent shares skidding 6%, to \$33.34.



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BY RICHARD S. DUNHAM

The Debates: Why Kerry Is the Underdog

ONE THING IS CERTAIN in the upcoming Presidential debates: George W. Bush won't be, to use his own word, "misunderestimated." After besting smartypants Al Gore four years ago in the court of public opinion—if not on debate points—Bush earned his spurs as an effective rhetorician whose folksy "average Joe"

approach in televised encounters has disarmed foes in three straight elections. And while Republican spinners will build up John Kerry as a brilliant debater with a track record worthy of the National Forensic League Hall of Fame, it is the President's challenger, not the President, who is on the spot as the debates open at the University of Miami on Sept. 30.

Kerry, whose eight 1996 Senatorial debates against Republican rival William Weld are the stuff of Massachusetts legend, will have to be in top form. After six months in the lead or deadlocked, the Democratic nominee has dropped behind Bush. Equally disconcerting to Dems, Bush now is the people's choice to handle two of the three top issues—terrorism and Iraq—while he's holding his own on the economy. The three Presidential debates and one Vice-Presidential face-off could be Kerry's last best chance to reshape the contest. "The debates are going to be enormously important," says his campaign manager, Mary Beth Cahill.

For Kerry to break through, he will have to survive a clash of debating styles. Bush tends toward the vernacular, while Kerry is far more formal. The plainspoken Bush needs to avoid factual error. The more cerebral Kerry needs to avoid condescension. Immodesty is "the common mistake senators make and why they don't get elected as Presidents," says Republican pollster Ed Goeas. "If Kerry falls back to where he's comfortable—I'm smarter than George W. Bush—he will lose the debates."

Americans, say Goeas, want a candidate who is "strong enough to govern." That's

why top Democrats say Kerry, while on the stage near Bush, must appear to be a plausible Commander-in-Chief. "The threshold issue [voters] want to be assured of is that they will be safe and their country will be safe," says House Minority Whip Steny Hoyer (D-Md.). To score, Kerry must outline his plans for the war on terrorism and postwar Iraq "with a great degree of clarity and forcefulness," says Hoyer.

Changing the Subject

THAT'S A CHALLENGE for a candidate derided as a congenital flip-flopper. But Kerry can't simply play defense on defense issues—he needs to change the subject. Zogby polls show that voters most concerned about terrorism favor Bush by 41 percentage points. Those more worried about the economy choose Kerry by 14. "As long as Senator Kerry engages the President on the war on terrorism, he loses," says pollster John Zogby. "He has to focus on the economy."

That could be difficult. Only one debate will be devoted to domestic concerns—the final one. History shows that "the first debate, not the last debate, is the most important," says Brookings Institution Presidential scholar Stephen Hess. "By the time they move to domestic issues, the election could be over."

Then again, debates are unpredictable, and stumbles by two incumbents—Ford and Carter—contributed to their defeats. But Kerry can't count on a Bush gaffe. To best the Prez, he must look smart but not elitist, strong but not strident, and decisive, not constantly inconstant. Even for a skilled debater, that's a tall order. ■

—With Mike McNamee



BUSH VS. GORE
Just plain George bested smartypants Al

DEBATE HOT SPOTS

Both President Bush and Democrat John Kerry must attempt to frame the election's top three issues. Here's how they'll try to sway voters:

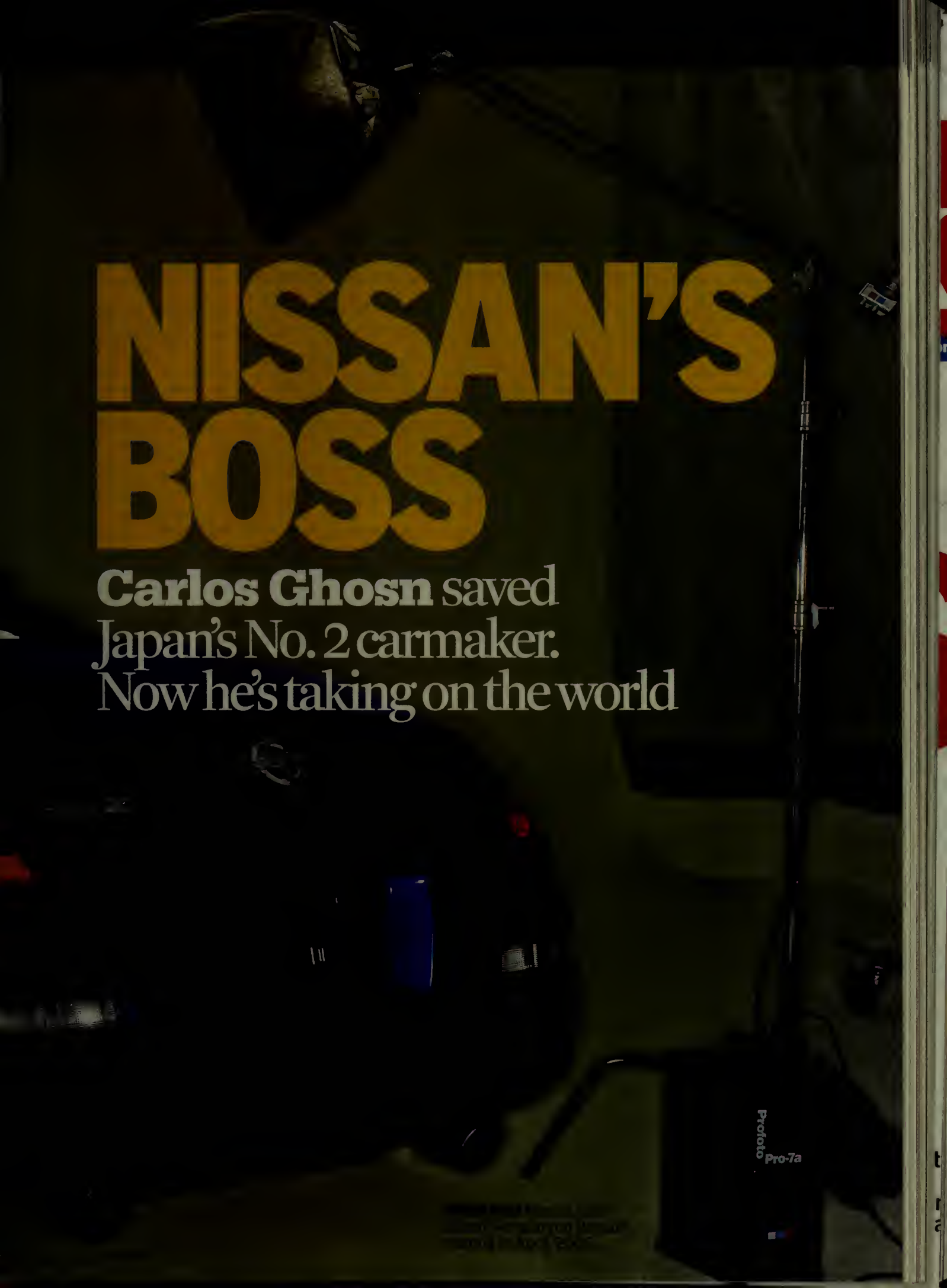
 **TERRORISM** With the President holding a commanding lead on this issue, Kerry must convince voters that Bush has put Americans at risk by creating a new generation of terrorists and fomenting anti-Americanism around the world. Bush will argue that his foe's multiple positions on Iraq demonstrate that Kerry would be an inconsistent leader who would make the world a more dangerous place.

 **IRAQ** The public has grave questions about Administration planning for postwar Iraq but does not believe that Kerry would handle the situation any better. The challenger must present a clear plan for Iraq's future and a plausible scenario for assistance from erstwhile U.S. allies. Bush must convince voters that there is light at the end of a bloody tunnel and that his brand of steadfastness offers the best hope for a positive outcome.

 **THE ECONOMY** Kerry will argue that Bush's massive tax cuts and Iraq spending have benefited the wealthy and corporate cronies while saddling middle-income Americans with the bill. He needs to persuade voters to accept a trade-off: higher taxes for some in exchange for expanded health care and initiatives to protect U.S. manufacturing jobs. The President hopes to paint Kerry as a typical tax-and-spend liberal who will destroy jobs by raising taxes on small businesses and investors.

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CARLOS GHOSN IS FLAT OUT THE HOTTEST AUTOMOTIVE talent on the planet right now, and he enjoys the kind of street cred that execs from Detroit to Stuttgart can only dream about. In Japan, a full five years after arriving from France's Renault to run Nissan Motor Co., CEO Ghosn is still fêted in manga comic books, mobbed for autographs dur-

ing plant tours, and generally heaped with national adulation for saving a car company once given up for dead. At glitzy auto shows from Paris to Beijing, his cosmopolitan air—Ghosn speaks five languages—and sterling track record for turnarounds make him a star attraction. He's as smooth as Thai silk in public, and his colleagues marvel at his personal magnetism, his 24/7 work ethic, and his rigorous attachment to benchmarks and targets. Heck, in Lebanon, where he is a citizen, Ghosn's name was floated a few weeks back as a potential candidate for President.

But Nissan insiders will also tell you there is another side to the 50-year-old car exec: If you miss a number or blindside the boss with a nasty development, watch out. "To people who don't accept that performance is what is at stake, he can be ruthless," says Dominique Thormann, a senior vice-president with Nissan Europe. Just ask managers at Nissan's 16-month-old, \$1.4 billion assembly plant in Canton, Miss., where sloppy craftsmanship marred the launch of the 2004 Quest minivan, the Titan full-

sized pickup, and the Armada sport-utility vehicle. Car enthusiast Web sites are full of rants about loose moldings, water leaks and noisy cabins. This spring, Nissan dropped from 6th to 11th in an annual quality survey by J.D. Power & Associates Inc. that tracks complaints in the first 90 days of ownership. Consumers quickly got wind of the troubles, and Nissan will have a tough time meeting its sales target of 80,000 Quests this year. In the

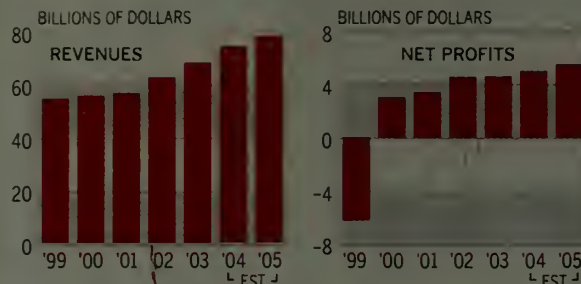
first half, fewer than 26,000 moved off dealer lots. In July the company mailed recall letters offering to fix any defects for free. "We've been surprised by the level of degradation," concedes Ghosn, whose own stress on speedy execution contributed to the quality woes. "We recognize it is a problem, and we will fix it."

Ghosn is fixing the Canton debacle in his characteristic fashion—that is, with the subtlety of a chain saw. In May, he flew in 220 engineers from Japan and Nissan's older Smyrna (Tenn.) plant. The dam-

age-control team searched every inch of the assembly line for flaws. Some were obvious: Factory hands, many of them newcomers to carmaking, wore rings and studded jeans that scratched freshly painted trucks. Other glitches were maddening: Power window switches and reading lights on the Quest often seemed possessed by gremlins, and its sliding doors didn't close quite right. So the team worked with suppliers to reengineer parts, while robots were reprogrammed to weld car bodies more tightly, and better insulation was added to the roof of the Armada. Then Ghosn shook up management, even raiding archrival Toyota to hire troubleshooter Douglas G. Betts as his new vice-president for assembly quality. As the 2005 Nissans enter deal-

BACK FROM THE BRINK

Under Ghosn, Nissan has prospered



All data for fiscal year ending March of following year
Data: Company reports. Credit Suisse First Boston



The Way Of Carlos Ghosn

Soon after Ghosn took over Nissan, he was receiving hate mail. Now he's revered in Japan, and considered a national hero. Here's how he got there:

1954

Born in Brazil to Lebanese immigrants.

1960

Family moves to Beirut. Young Ghosn attends a Jesuit high school where he quickly picks up French and Arabic as well as Portuguese.

1974

Graduates with engineering degree from the elite Ecole Polytechnique in Paris.

1978

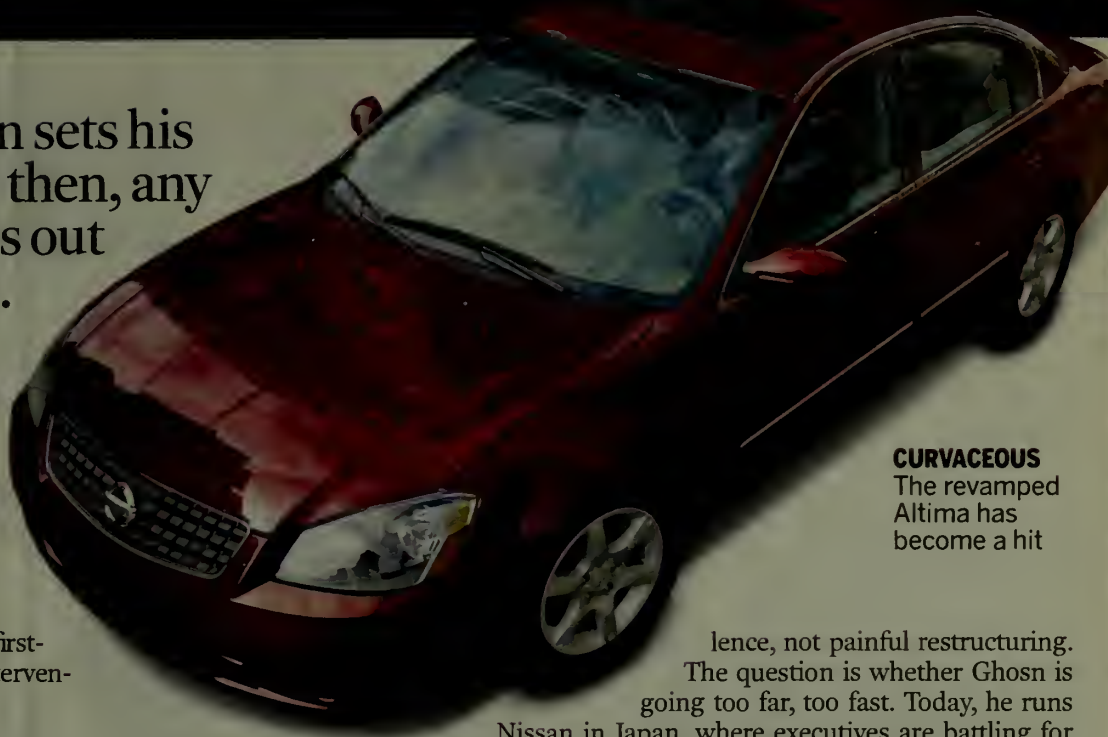
Recruited by tiremaker Michelin.

1990

Michelin merges with B. Goodrich, and Ghosn



A Winner Ghosn sets his targets high—and then, any way he can, figures out how to meet them. One quirk of his management style is to drop in unannounced



CURVACEOUS
The revamped Altima has become a hit

erships this fall, buyers will learn first-hand whether Ghosn's personal intervention has paid off.

LOFTY TARGETS

IT'S THE GHOSN WAY: detailed planning, speedy execution, and a laser focus on what needs fixing. Since 1999, when Renault paid \$5.4 billion for a controlling stake in Nissan and dispatched Ghosn to Tokyo to run it, he has set—and met—sales and profit targets that have stretched the auto maker to the limit. That pattern appeared in 1990, when Ghosn turned around Michelin's North American division, and in 1996, when as chief operating officer of Renault he kicked off a program to cut \$3.6 billion in annual expenses. Such acts earned Ghosn the overused sobriquet *le cost killer*. It is a name he loathes and hopes to banish for good by building an enduring car company based on product excel-

lence, not painful restructuring. The question is whether Ghosn is going too far, too fast. Today, he runs Nissan in Japan, where executives are battling for share in a soft market by launching six new models, and where preparations for a major expansion into China are under way. Since last spring, Ghosn has also taken charge of North America. And in April he starts his new job—replacing his mentor Louis Schweitzer as CEO of Renault, a \$46 billion giant in its own right and the controlling shareholder in Nissan, with a 44% stake. Incredibly, Ghosn will continue to run Nissan from Tokyo headquarters even as he maintains oversight of U.S. operations.

Will this guy have to clone himself? Running two such complex organizations is a fiendishly difficult task, but Ghosn insists that he's ready—and that he needs to stay on at Nissan to keep the company headed in the right direction. "I won't be a part-timer, but one CEO with two hats," he says.

One CEO, as well, with an audacious plan to create what

sees a grueling overhaul
EO of U.S. operations.

96

Renault as chief of
arch, manufacturing, and
nasing. He's soon lionized
shareholders as "le cost
" for slashing budgets by
billion but reviled by
ers for job cuts.

99

ult shocks the industry
fering \$5.4 billion for a
e in struggling Nissan.
n is named chief
ating officer.

00

an posts \$6.2 billion
Ghosn appointed
ident and pushes revival
that calls for eliminating
plants and 20,000 jobs.



PROTESTERS IN BELGIUM PRIOR TO A PLANT CLOSURE

2001

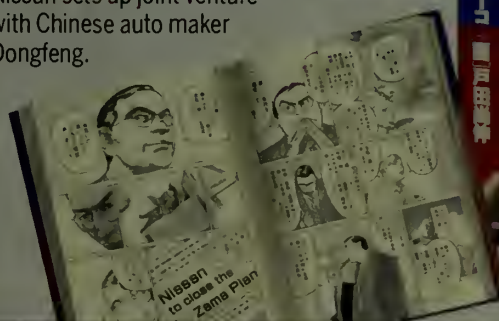
Ghosn moves up to Nissan CEO as the auto maker returns to profitability.

MAY 2003

Production starts at Nissan's \$1.4 billion plant in Canton, Miss.

JULY 2003

Nissan sets up joint venture with Chinese auto maker Dongfeng.

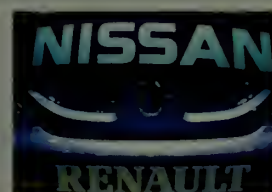


APRIL 2004

Glitches with vehicles made in Canton hurt Nissan's ranking in quality surveys.

MAY 2004

Ghosn announces an initiative that aims to launch 28 new models by 2008 and



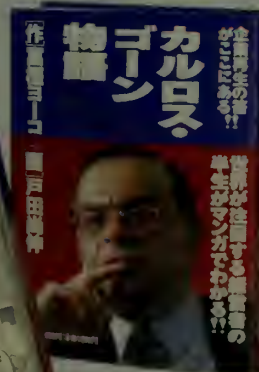
take the Infiniti luxury brand global.

APRIL 2005

In an industry first, Ghosn will assume the title of CEO at two global auto companies: Renault and Nissan.

Data: Company reports
BusinessWeek

GHOSN IS A CULTURAL ICON IN JAPAN



Daimler Benz and Chrysler Corp. could not—a successful global auto group from two very distinct companies. Renault and Nissan have been quietly cooperating on technology and parts buying for years. But this Franco-Japanese collaboration is set to expand significantly shortly after Ghosn arrives in Paris, in everything from parts purchasing to wholesale platform-sharing to engine design. Already, Nissan and Renault sell a combined 5.4 million vehicles a year and control 9.3% of the global market. If they were one company, it would be the fourth-largest auto maker on earth, ahead of DaimlerChrysler and right behind Ford. Ghosn says no full-fledged merger is coming—but his accession to the double thrones of Renault and Nissan signals that far deeper ties lie ahead.

TOP SPEED

AT THIS CRUCIAL MOMENT, when Ghosn can't afford a slipup, the Canton problems highlight the perils of his turbocharged management style. Carmakers know that doing too many new things at once is risky, so new plants typically make tried-and-true models, while fresh designs are usually built by seasoned workers at established factories. In Canton, though, Nissan launched five new models in less than eight months. "There was a need to get the products to market as soon as possible," says Dave Boyer, vice-president in charge of Nissan's U.S. manufacturing operations and head of the Canton plant. Ghosn today acknowledges that he may have stretched too far. And one Nissan executive, who asked not to be named, grouses that the company's cost crackdown on suppliers may have aggravated the problems. "So much effort was spent getting costs down that the quality issue went unnoticed—until it was too late," this manager says.

Ghosn says he's starting to get a handle on the quality woes. Yet at the same time he's upping the ante for Nissan's U.S. operations, which continue to grow thanks to the revamped Altima sedan and Pathfinder SUV. "I can already commit that our [quality] scores will be much better," he says. On Sept. 2, he boosted his 2004 sales target for the U.S. to make up for soft results in Japan and Europe. Ambitious, yes, but necessary if Ghosn is to reach a goal he set two years ago of annually selling 1 million more cars—an increase of 38% over three years—by September, 2005. And forget about goosing sales with rebates. "We spent five years reining in in-



ARMADA SUV
Quality at
Canton has
been an issue

centives, and we're not going to give it back in five months," says Jed Connelly, chief of U.S. sales. Indeed, Nissan incentives in August averaged \$1,559 a vehicle, compared with nearly \$4,000 at Ford and General Motors Corp., according to auto data Web site Edmunds.com.

Can even a superstar such as Ghosn stay on top of industrial operations as vast as Nissan and Renault? Plenty in the industry would love to see the brash Ghosn stumble. The truth is, though, Ghosn has built a powerful machine. "It's tough to keep" a turnaround going, says GM boss G. Richard Wagoner Jr. "But it would be foolhardy to underestimate Nissan."

As turnarounds go, the Nissan saga is in a class by itself. In 1999 the company was straining under \$19 billion in debt and shedding market share in both Japan and the U.S. Ghosn was also being undermined by Nissan insiders who wanted his reforms to fail. So when he was about to announce the

closing of five factories, he didn't tell his own board of directors until the night before, recalls Jason Vines, who served as Nissan's North American public-relations chief early in Ghosn's tenure and now heads PR for Chrysler Group. And to ensure those in the know wouldn't spill the beans, Ghosn threatened: "If this leaks out, I'll close seven plants, not five," Vines says. That boldness—and the factory shut-downs—led to menacing hate mail, and Ghosn began to travel with a bodyguard.

These days, though, Ghosn is more hero than target. Last year, Nissan reported profits of \$4.6 billion on \$68 billion in revenues, up 8%. It looks set to boost earnings by another 6% and sales by 9% this year, brokerage Morgan Stanley says. Nissan's \$49.7 billion market capitalization is the second biggest in the industry, after Toyota's. It has overtaken Honda as No. 2 inside Japan. And Nissan leads the global pack in operating margins (11.1%).

Despite the problems with Canton, the brand is hot again. Nissan is turning out daring designs such as its sleek-but-muscular 350Z sports coupe, the curvaceous Altima sedan, and the round-backed Murano crossover. And in Japan, stylish numbers such as the March subcompact and the boxy Cube micro-van are driving sales. That's part of Ghosn's push to create what he calls "segment-defining" models. "Consumers either like a car or they don't, but that is O.K.," says Nissan design chief Shiro

Potholes

6th

NISSAN'S
RANKING
IN 2003

11th

NISSAN'S
RANKING
IN 2004

Initial quality survey
of 14 auto makers

Data: J.D. Power and Associates

CANCER

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Bristol-Myers Squibb Company

Hope, Triumph, and the Miracle of Medicine

Nakamura. As long as a model isn't a bore and hits profit goals along the way, Ghosn gives his designers pretty free rein.

Yet the detail work needs to come up. The quality problems at Canton aren't the only difficulties the company has faced. Take the Quest minivan. First, Nissan underestimated demand for popular features such as snazzy skylights. What's more, the beige interior on the entry model turned off family buyers fearing spills from toddlers. Now, the Quest is getting big design changes, including darker interiors and sunroofs even in the cheapest versions. "You will see incredibly different results this fall," says Walt Niziolek, manager of Visteon's Mississippi plant, which makes many Quest cockpit parts.

Nissan still has some gaps in its lineup, too. It won't have a sub-\$15,000 compact—a growing segment critical to brand loyalty that Toyota has exploited with its Gen Y Scion brand—until 2007. Ghosn continues to be skeptical of environment-friendly hybrid cars. So Nissan's first hybrid, a gasoline-electric Altima, won't hit showrooms until 2006. And even where it's filling gaps, Nissan needs to work out some kinks: The Titan, the first full-size pickup truck out of Japan, has been a disappointment. Consumers haven't been flocking to this monster as Detroit's Big Three kick in incentives on their models that are worth roughly twice the \$1,500 Nissan offers on the Titan.

Ghosn, though, isn't postponing his return to the CEO's job in Paris. One factor in his favor is that Schweitzer—who will remain chairman of Renault—has done a good job spiffing up the French auto maker (page 58). Renault is now the top-selling brand in Europe and, after tough restructuring, is light years away from its days as an industrial basket case. Quality still needs to come up. But thanks to rising profits and a deserved reputation for inspired design, Renault is on the offensive. It plans to hire 10,000 workers in 2005 to raise production in emerging markets such as Turkey, Slovenia, Russia, and Romania, where it has opened a plant to build a \$6,000 sedan called the Dacia Logan. Renault has profited handsomely from Nissan, too: Its initial \$5 billion stake has more than tripled in value.

More important for the company's global

ambitions, Schweitzer and Ghosn have a stealth vehicle to drive integration. Early on, Schweitzer set up an Amsterdam-based company, Renault-Nissan BV, as a neutral forum where both sides could map out a common strategy for product engineering, model development, and computer systems, and leverage their combined size to squeeze suppliers for better deals. Once a month, Renault-Nissan's eight board members—four from each side—meet to make medium- and long-term decisions based on proposals by a dozen cross-company teams. Already about 70% of the parts used by the two auto makers are jointly purchased by the alliance.

The integration has been surprisingly smooth—in sharp contrast to the tumultuous marriage of Daimler and Chrysler. Renault today builds its Clio compact and Scenic minivan at Nissan plants in Mexico, while Nissan makes its Frontier pickup at a Renault factory in Brazil. The ultimate goal is to reduce the number of platforms, or chassis, the group uses to 10 in 2010 from the 34 it had in 2000. The goal is in sight: Nissan had 24 individual platforms in 1999, but uses only 15 today. That's important, because every shared platform can add \$500 million-plus in annual savings for each carmaker, estimates Commerzbank. Renault will also share eight engine designs with Nissan.

When conflicts do arise, Schweitzer and

Daring Ghosn gives designers freedom, as long as the cars hit profit targets and aren't boring

HOT AT HOME
The Cube is selling well in Japan



Ghosn's Report Card

Key to Ghosn's management style is laying out ambitious goals in multiyear plans with catchy names. Here are his three big initiatives—and how he has fared.

"REVIVAL PLAN"

GHOSN'S INITIAL BID TO SAVE THE CAR MAKER
2000-03

- Cut purchasing costs 20% and halve number of suppliers **ACHIEVED, 2002**
- Trim workforce by 14%, to 127,000 **ACHIEVED, 2002**
- Shutter three car and two engine plants **ACHIEVED, 2002**

"180 PLAN"

INITIATIVE AIMED AT MAKING NISSAN A GLOBAL PLAYER
2002-05

- Increase annual sales by 1 million vehicles, to 3.0 million **3.0 MILLION SOLD, 2003**
- Operating profit margin of 8% **ACHIEVED 10.8%, 2003**
- Zero net debt **ACHIEVED, 2003**

"VALUE UP"

PLAN TO KEEP NISSAN IN THE PASSING LANE
2005-08

- Maintain return on invested capital of 20%
- Increase sales to 4.2 million cars and trucks by 2008
- Maintain 10% or better operating margin

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Ghosn usually hash things out before alliance board meetings. After Renault acquired South Korea's Samsung Motors in 2001, the French company wanted Nissan to design the next large 4x4 sport utility for the Korean company. Ghosn resisted, but was finally swayed by Schweitzer's logic: Nissan had the best know-how in SUVs, so it should take the lead. It wasn't altruism on Ghosn's part, mind you: Nissan will get a royalty from Renault on each of the SUVs that is sold when it launches in 2007. "Every time there was a difficult decision," says Renault CFO Thierry Moulounguet, "Schweitzer and Ghosn worked out the right balance."

That's remarkable, given how different the two men are. Schweitzer, an intellectual who persuades with logic and nuance, prefers to lead from above. Ghosn, on the other hand, is in-your-face and reaches deep into an organization by constant—and often unannounced—visits to dealerships, test tracks, assembly plants, and parts suppliers. And he isn't shy about setting sky-high targets. Toshiyuki Shiga, a senior vice-president in charge of emerging markets for Nissan, recalls getting a call from Ghosn in early 2000. First the good news: Shiga had been promoted. Then the zinger: "He told me to make a clear strategy for Nissan in China, and he gave me two months to do it," laughs Shiga. Back then, Nissan sold just a few thousand vehicles in China annually, mostly imported from Japan. Shiga, though, jumped into motion and hatched a plan that led to a 50-50 joint venture with China's Dongfeng Motors. The duo just opened a plant in Guangzhou that will roll out six new models next year. Although Nissan is far behind market leaders Volkswagen and GM, the venture hopes to sell some 620,000 cars and trucks in China by 2007, double last year's level.

It's those surprise visits that really seem to energize Ghosn. On a recent swing through Nissan's Iwaki engine plant, 110 miles north of Tokyo, he was mobbed by eager factory hands. He doubtless enjoyed the attention, but at each stop it was evident he was looking for nuggets that would help him squeeze yet another ounce of productivity from the plant, which cranks out V-6 engines for such models as the 350Z and the upscale Infiniti G35 luxury sedan. He worked the floor, chatting up assembly workers, drilling foremen, all to get that extra fact that would edge the company forward. Even if he got no cost-killing tips from line workers on this particular day, the visit clearly paid off for Ghosn, who knows he is nothing without an inspired workforce. "The only power that a CEO has is to motivate. The rest is nonsense," he says. As his next act begins, Ghosn's motivational powers must be stronger than ever. ■

—By Brian Bremner in Tokyo, Gail Edmondson in Paris, and Chester Dawson in Los Angeles, with David Welch and Kathleen Kerwin in Detroit

MICRA It shares design DNA with a Renault



Two Heads Of A Global Giant

Nissan and Renault combined would be the world's fourth-largest auto maker

NISSAN

Revenues
\$68.0
BILLION

Net Profit
\$4.6
BILLION

Operating Margin
11.1%

Stock Appreciation*
267%

Sales
3.0
MILLION VEHICLES

Market Cap
\$49.7
BILLION

*Since Jan. 1, 1993, after reinvesting dividends.
Nissan's 2003 concept sales for fiscal year ended March 2004.
Renault's 2003 concept sales for fiscal year ended March 2004.
Data: Bloomberg, Reuters, MarketWatch

RENAULT

Revenues
\$46.1
BILLION

Net Profit
\$3.1
BILLION

Operating Margin
3.3%

Stock Appreciation*
105%

Sales
2.4
MILLION VEHICLES

Market Cap
\$23.7
BILLION

*Since Jan. 1, 1993, after reinvesting dividends.
Nissan's 2003 concept sales for fiscal year ended March 2004.
Renault's 2003 concept sales for fiscal year ended March 2004.
Data: Bloomberg, Reuters, MarketWatch



DEALS Smoothest Combo On the Road

When Renault nabbed a controlling stake in Nissan in 1999, skeptics howled that the \$5.4 billion investment would

bankrupt the French carmaker. But Renault Chief Executive Louis Schweitzer had a grand vision. Nissan, he believed, could become a pillar of a globe-spanning alliance that would help boost Renault from a regional player to one of the world's top carmakers. "In the short term, Nissan needed Renault. In the long term, Renault needed Nissan," says Philippe Lasserre, professor of strategy at INSEAD management school in Fontainebleau.

Against all odds—just ask the managers of the DaimlerChrysler-Mitsubishi alliance—Schweitzer's vision has become a reality. Together, Renault and Nissan sold 5.4 million cars in 2003, placing them fourth behind General Motors, Toyota, and Ford. Nissan already enjoys the fattest margins of any big industry player, while Renault is Europe's No. 1 brand and is expanding rapidly into developing markets. Now, Schweitzer—together with his designated successor, Nissan CEO Carlos Ghosn—is ready to hit the accelerator. "I don't feel we have reached the potential of what this alliance can achieve," Schweitzer says.

That's a big change from 1999, when neither Nissan nor Renault struck anyone as a global contender. But while Ghosn was slashing costs and dismantling supplier *keiretsu*, Schweitzer was putting the French giant through its own paces—with a helping hand from Tokyo. Schweitzer sent dozens of Renault managers and hundreds of factory hands to Nissan plants to bone up on everything from the

HARMONY The Renault Modus minivan is a joint product

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BROADER FOCUS Can Ghosn (front) boost large-car sales when he succeeds Schweitzer?

most efficient way to hold screw guns to strategies for flattening management hierarchy. Then in 2003, Renault imported 100 Nissan employees to help oversee the launch of the Megane compact sedan, which helped trim both launch and warranty costs (the company declines to say by how much).

Schweitzer also shook off Renault's parochial French management culture and began pushing his global strategy. He set up assembly lines in Russia, Turkey, Iran, and Brazil. In 1999 he snapped up Romania's hapless Dacia brand, investing a total of \$1.5 billion over five years. The goal: Use Romania's cheap but skilled workforce to make a \$6,000 car for developing markets. That push bore fruit on Sept. 9, when Dacia launched its no-frills Logan sedan. By 2010, Renault expects to sell as many as 700,000 Logans annually from Bucharest to Bombay. "While we were making the technological move to cooperate with Nissan, Renault went global," says Pierre-Alain De Smedt, Renault's engineering chief.

La plus grande surprise: To get the global message across, English is now the lingua franca at Renault's Paris headquarters—and top managers must pass tests to make sure their language skills are up to snuff. English is also the language of the 12 cross-company teams from Nissan and Renault that meet once a week by phone or in person to hammer out collaboration in everything from anticorrosion solutions to

engine technology. The process can be laborious, but it pays off in harmony. In a recent deadlocked debate about which powertrain to use on a common platform, De Smedt and his Japanese colleagues needed six months to sort out a decision. "We don't force issues," says De Smedt.

Another big Schweitzer push: safety. Renault now ranks No. 1 in Europe in crash tests performed by London-based Euro N-Cap, and all five of its major model lines have earned five stars, the top score. Toyota ranks No. 2 with three models fetching five stars. "Renault has become the new Volvo," says Commerzbank analyst Adam Collins.

True, Renault's foray into new markets

Revved Up
The first major cost savings from sharing engines and components with Nissan will hit Renault's bottom line next year

has squeezed earnings. Operating margins fell to 3.7% last year from 6% in 1999. But analysts say the company is poised for strong growth and rising profits. Sales in the first half of this year rose 11%, to \$25 billion, and net profits surged 28.5%, to \$1.84 billion, buoyed by a hefty dividend from Nissan, strong sales of the Megane series, and growing earnings in developing markets. And starting next year, the first real cost savings from shared components and engines will hit the bottom line, after the debut of Renault's first two models developed in conjunction with Nissan: the Logan and the Renault Modus minivan, which shares much of its genetic material with the Nissan Micra. For Renault alone, the cost savings from such sharing could reach \$550 million next year and twice that in 2006,

Commerzbank estimates.

Ghosn will still face challenges when he takes over as CEO next April. One thorny problem has been larger cars, an area where the French giant has been traditionally weak. Analysts say Renault will sell fewer than 10,000 of its \$38,000 Vel Satis luxury sedans this year, a fraction of the initial target of 50,000. In Romania, meanwhile, Dacia is running smoothly, but the expat management team that has been in charge is now gradually handing control back to locals. Another dilemma: Ghosn will have to decide whether to bring Renault back to the fiercely competitive U.S. market. Schweitzer has said Renault aims to return to the U.S., but not before 2010, giving it time to develop new models tailored to American tastes. Finally, Ghosn will have to keep Renault's global push on the growth track, and deepen the integration between Tokyo and Paris. "There is much more to do to unlock the cost savings and economies of scale," says Garel Rhys, professor of automotive economics at Cardiff Business School at University of Wales. "Both companies have to fire on all cylinders." At least when Schweitzer hands the keys to Renault over to Ghosn, he'll have the satisfaction of knowing his grand alliance has passed more milestones than anyone thought possible five years ago. ■

—By Gail Edmondson in Paris

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(knowing it gets you that much closer to a mountain bike: priceless)



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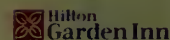
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Loyalty Programs

Miles, Points and Service Bring Travelers Back

What Frequent Business Travelers Know

Even as the travel industry struggles to recover, one perk – frequency programs, has remained intact. In fact, many programs have been enhanced, some dramatically – a nod toward the travel supplier's understanding of the vital importance of customer loyalty. For travelers, it's never been easier to accumulate balances, and the choice of rewards has never been greater.

So how can you maximize points? Business travelers in the know have a number of strategies such as using loyalty programs that are generous with points, offer a variety of flexible reward options and don't require an airline ticket purchase to earn balances.

Hampton Inn®, Hampton Inn & Suites®, Hilton Garden Inn®, Hilton Grand Vacations Club®, Homewood Suites by Hilton® and Scandic hotels, making Hilton HHonors one of the largest hotel rewards programs in the world.

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Hilton HHonors® Gets Personal with New Earnings Options

New Individualized Benefit Enables Travelers to Maximize Points & Miles®

How would you like to be rewarded?

Hilton HHonors, one of the world's leading hotel rewards programs, recently launched a new earnings options program that allows members to personalize how they are rewarded for their Hilton family hotel stays. From now through December 31, 2004, members can choose from among three Double Dip Earnings Style options.

HHonors members interested in maximizing their miles now have two choices. Members with longer stays can select Points and Variable Miles – ten HHonors Base points plus one airline mile per eligible dollar spent during their stays. Members with shorter stays can select Points and Fixed Miles – ten HHonors Base points plus 500 miles per stay (100 miles at Hampton Inn®, Hampton Inn & Suites® and Scandic hotels). Members who prefer to concentrate on points can choose Points and Points – ten HHonors Base points plus five HHonors bonus points per eligible dollar spent.

These new earnings options give HHonors members the opportunity to Double Dip *their* way and choose the benefit that best suits their travel style.

Members can choose the Double Dip option most appealing to them at any time prior to any stay by changing their profile preferences online or via phone to the Hilton HHonors Customer Service Center. And members can change their earning preference anytime – even with every stay, if they wish.

"These new earnings options give HHonors members the opportunity to Double Dip *their* way and choose the benefit that best suits their travel style," said Mary Beth Parks, vice president of marketing for Hilton HHonors Worldwide. "It's another example of the way Hilton HHonors meets the individual needs of our members."

Hilton HHonors members can take advantage of the new Earnings Style options at more than 2,500 Hilton Family hotels worldwide. For more information and detailed terms and conditions about the Hilton HHonors Earnings Style benefit, visit hiltonhhonors.com/myway.

on gift ideas for clients, friends, family and business associates.

Join loyalty programs that offer points that are valid with the most supplier partners, whether they're travel-related

or not. For those road warriors who'd rather not spend points on more time away from home, there are hotel loyalty programs like **Radisson Gold Rewards**, which benefits members not only with hotel stays and flights but with GoldPoints that may be used at various restaurants and upscale retailers like Skymall. GoldPoints can also be earned at retailers such as FTD.com, through Thrifty Car Rental, hotel partners of Radisson, including Country Inns & Suites by Carlson, Park Inn Hotels, Park Plaza Hotels, Radisson SAS properties in Europe, the Radisson Edwardian group in the United Kingdom, and at T.G.I.Friday restaurants.

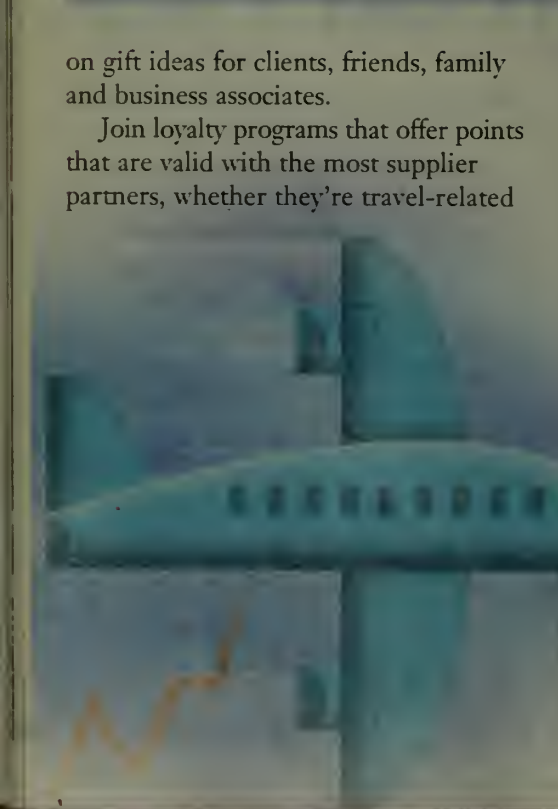
Watch for special programs on airline shuttle flights. The Delta and US Airways shuttles along the Eastern Corridor, for

example, run frequent promotions awarding as much as 5,000 miles for a roundtrip flight.

Book a flight through the carrier's own Web site. Members of airline frequent flyer programs who book directly often get bonuses of 1,000 points or more for new routes, or during special promotions that figure can jump to 5,000 points.

Use an airline's special Web-based features whenever possible. American Airlines offers mileage bonuses for redeeming award trips online instead of on the phone or by mail. To encourage usage, many carriers also are offering substantial point bonuses for online flight check-in as well.

Be aware that if you book through certain discount Web sites, such as priceline, hotels.com or hotwire.com, you may not earn miles or points.





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BRITISH AIRWAYS





Buy the points you need to reach an award level. Many frequency programs allow you to buy blocks of points in increments of 1,000 to reach the minimum threshold for an upgrade or a free airline ticket. Members of the **British Airways Executive Club** program in over 190 countries can now buy BA Miles online at www.ba.com, enabling them to reach reward redemption levels quickly. "At British Airways, we are continually looking for ways we can add value for our most loyal customers," said Simon Parks-Smith, British Airways' head of product management. "An online tool for purchasing miles allows members to easily top up their balance

An online tool for purchasing miles allows members to easily top up their balance of BA Miles accounts and book reward flights sooner.

of BA Miles accounts and book reward flights sooner."

The online tool was built by Points International Ltd., the independent loyalty points exchange firm that allows consumers to exchange points and miles from one participating loyalty program to another. Points Exchange has, to date, attracted close to 40 partners, including eBay-Anything Points, American Airlines-the AAdvantage program,

InterContinental Hotels-Priority Club Rewards, Air Canada-Aeroplan, Delta Air Lines-Sky Miles, Imperial Oil-Esso Extra, GiftCertificates.com, Fairmont Hotels & Resorts-The President's Club, Cathay Pacific Airways-Asia Miles, America West Airlines-FlightFund, Alaska Airlines-Mileage Plan and Sprint.

Sign up for affinity cards, and channel as much purchasing as you can through them. Marriott recently launched a loyalty card for small businesses: the **Marriott Rewards Visa Business Card**. With it, your company will earn one point for every dollar spent; three points for every dollar spent at a Marriott property.

Another affinity card with generous rewards is the **Amtrak Guest Rewards Mastercard**. As with most airline frequent flyer cards, you earn one point per dollar spent. But unlike airline frequent flyer programs, which typically

require 25,000 miles for a free trip, rewards at Amtrak start at 1,000 points in California and 2,500 points on the East Coast. Amtrak points can also be converted to miles on United, Midwest Express or Continental, or can be used at Hilton, Starwood and Marriott hotels.

Remember that discount carriers also have loyalty programs – sometimes, generous ones. **America West's** award-winning frequent flyer program,

Tip: Use Hotel Programs to Reach Elite Status Quickly

Marriott International Inc.'s Rewards program allows members to achieve Elite status faster than ever before and receive exclusive benefits across all Marriott brands that participate in the program. For example, all Marriott Rewards members can now request hotel stay awards just 24 hours before check-in to most participating hotels by calling 1.800.450.4442 or by visiting marriottrewards.com. Additionally, Marriott Rewards members can earn Silver Elite status and benefits after spending just 10 nights per year (previously, 15 nights were required.)

In addition to free hotel stays, members have more than 300 different reward options, including Nick Faldo and John Jacobs golf schools; spa packages; luxury cruises; car and SUV rentals from Hertz; theme park passes to Disney, Universal Studios and Discovery Cove Orlando, and a variety of retail merchandise. To enroll in Marriott Rewards, call 1.800.249.0800 or log onto marriottrewards.com.

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*Based on seven nights at Starwood, Hilton, InterContinental Hotels Group, and Hyatt full-service hotels of similar quality and points earned on dollars spent. Assumes standard award offerings for base level members. All comparisons are as of 07/04 © 2004 Marriott International, Inc.

FlightFund, offers elite benefits that include unlimited space-available upgrades, mileage bonuses, preferred seating, priority check-in and early boarding. Unlike traditional frequent flyer programs, **JetBlue Airways' TrueBlue** members earn points instead of miles for flights flown. The airline has classified each of its routes as short, medium or long haul; customers earn points for each one-way trip (two points for a short flight, four for a medium flight, six points for a long flight). A free roundtrip ticket, good for any destination JetBlue flies, is awarded once a customer reaches 100 points. When that threshold is reached, you're immediately notified via e-mail.

At **AirTran**, the **A-Plus Rewards** system is based on how often you fly and whether you fly in Coach or Business Class, rather than how long the flight is. A one-way coach flight earns one point; one way in Business Class is 1.5; every \$1,000 spent on the AirTran Airways A-Plus Visa Card earns two points; 0.5 points for a Hertz rental. Rewards begin at four points, for a one-way business-class upgrade.

Channel your spending to the fewest number of suppliers rather than scattering points across several programs.

Channel your spending to the fewest number of suppliers rather than scattering points across several programs. The goal: to reach elite status as quickly as possible, because then you can earn points even faster than before. For example, members of **British Airways Executive Club Gold** earn a 50 percent bonus of BA miles on British Airways and Qantas.

Look to airline alliances to maximize reward options. With Star Alliance, for example, if you join the frequency program of one Alliance member, you can earn/redeem points on the 15 member airlines. And when you reach elite status levels in one member program, you'll receive the equivalent Star Alliance status level.

Meantime, Northwest airlines just joined SkyTeam, the alliance of nine

global carriers formed four years ago. (The alliance also includes Aeromexico, Air France, Alitalia, CSA Czech Airlines, Delta Air Lines and Korean Air.) In addition to integrated frequency programs, the nine airlines in SkyTeam have access to 27 hub airports around the world, offering a total of nearly 14,000 daily departures.

Tips for Frequent Travelers:

- **Learn how to work with blackout dates.** American Airlines has just begun publishing the AAdvantage Hot Spots calendar on its Web site, allowing travelers to check for dates when seats are available for certain AAdvantage award seats. (The advantage for business travelers: no more checking from day to day to see whether an award seat has opened up.) The calendar extends out five months and is updated weekly. For now, it's limited to a few major cities, but by next year, it is expected that the entire network will be listed.

- **Channel everyday business spending (not just travel spend) to a charge card linked to a rewards program.** American Express is working with vendors to encourage card payments for business expenses that are usually direct-billed, such as advertising. "The Los Angeles Times was used to direct billing, and didn't expect customers to

won't have upgrade eligibility until three days prior to departure. Similarly, Air New Zealand has just changed its program to issue frequent flyer rewards based on dollars spent rather than miles flown.

- **Don't think financially challenged airlines have given up on their frequent flyer programs.** United Airlines has just reduced – for the third time this year – the number of miles needed for frequent flyer award travel. United Economy Saver award travel booked on united.com will be available for 15,000 miles instead of 25,000, and United First or United Business Saver award travel will be available for 30,000 miles instead of 40,000. This award travel is for most nonstop, roundtrip flights that are 750 air miles or less each way on United, United Express or Ted.

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want to put \$100,000 a month on a Corporate Purchasing card," said Anré Williams, executive vice president, U.S. Commercial Card for American Express. "Now they're very happy with that volume. The customer is happy, too: that's 100,000 Membership Rewards points every month, the equivalent of four roundtrip coach tickets the company can use for future business trips, or to hand out as merit rewards.

- **If you have to pay higher fares, at least reap better rewards.** Alaska Airlines' top-level frequent flyers who purchase full fares will be given automatic, space-available upgrades to the first-class cabin at the time of booking. Elite-level travelers on discounted fares





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Can Televisa Conquer the U.S.?

Azcárraga envisions a Hispanic media empire stretching from Mexico to Maine

WHEN EMILIO AZCÁRRAGA Jean took over the family media business seven years ago, investors worried that the then-29-year-old scion might just be a lightweight. But today, at the helm of Grupo Televisa, Mexico's leading broadcaster and the world's largest media company, Azcárraga is proving he is a media exec to be reckoned with.

Just ask A. Jerrold Perenchio, the

powerful chairman of U.S.-based Hispanic media giant Univision Communications Inc., which gets most of its programming from Televisa. Three years ago, Azcárraga decided to play hardball with Perenchio, fed up with what he believed were the paltry payments Televisa was receiving for its highly rated soap operas and variety shows. The two companies were locked into an exclusive programming deal

Televisa isn't quite ready to make a play for Univision

THE SCION
Azcárraga, 36, has proved he's a worthy successor to his father

that runs to 2017 but Azcárraga still stood up to his American partner to negotiate higher royalties. Next, the

National Football League, eager to make its sport more international, felt Azcárraga's bite. Last year he yanked NFL games—including the Super Bowl—off the air in Mexico for the whole season after a 35-year run because he felt Televisa was overpaying for the broadcast rights. On Aug. 12 the league and Televisa announced they had finally reached a new pact, starting with the NFL's Sept. 9 season opener. No terms were released, but Televisa execs were clearly pleased with the deal.

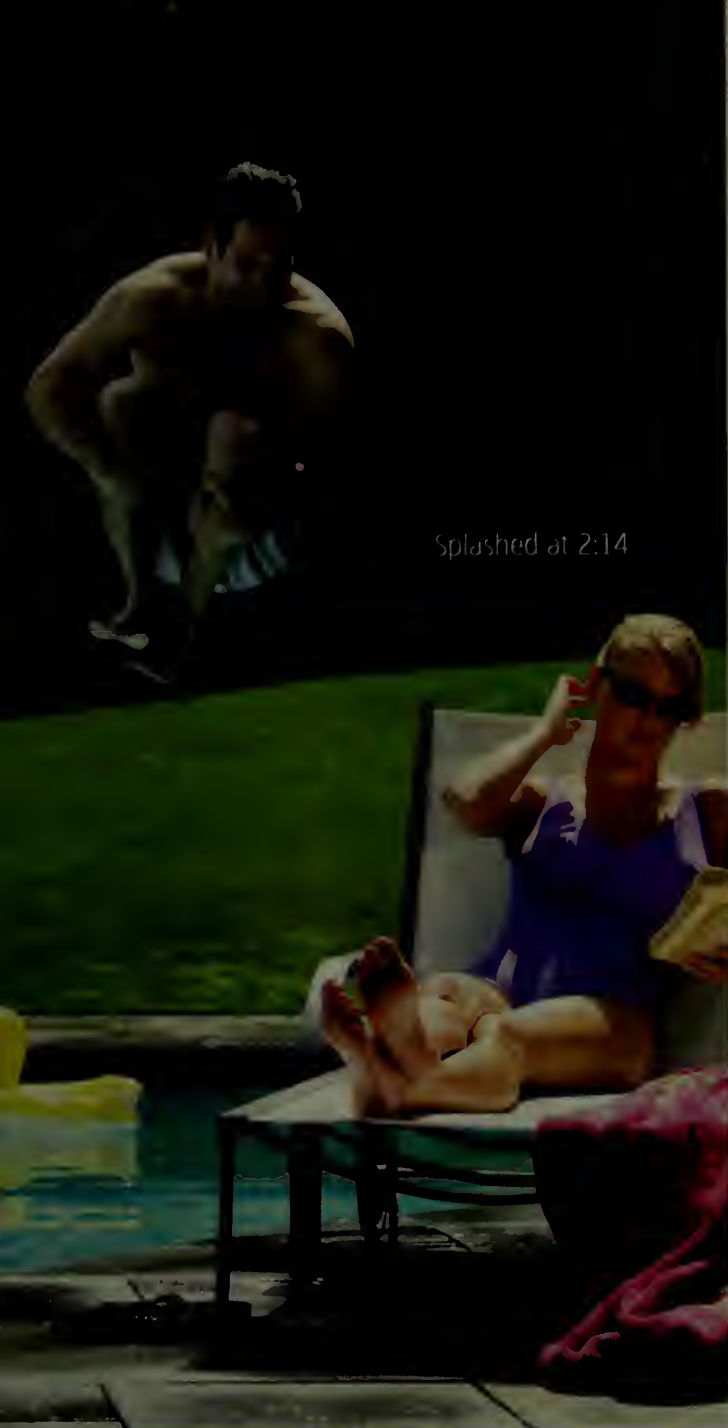
Azcárraga can afford to throw his weight around. After all, as the world's premier producer of top-rated Spanish-language programming, Televisa can deliver Hispanic eyeballs to TV sets at a time when marketers are clamoring for that audience's fast-growing economic clout. Today, Azcárraga is among the most closely watched media execs in the world.

His ambitions are grand: He wants to go beyond providing content to others and create a North America-wide Spanish-language media empire comprising broadcast, Internet, publishing, and live events. "For me, the ideal thing would be to do a Televisa-Univision [merger], but if we put together Televisa and [another] American partner, I'd be happy with that, too," Azcárraga said in an interview in his Mexico City office overlooking the network's sleek news studios.

GO-IT-SLOW APPROACH

SO SERIOUS IS AZCARRAGA that he says he may even do a Rupert Murdoch—winning U.S. citizenship to get around federal rules restricting foreign ownership of U.S. broadcast properties. That would allow him to launch a bid to control Univision should Perenchio ever loosen his grip. At the same time he's aware he must build Televisa's market value before paying out huge sums that might upset the very investors he has worked hard to win over.

Yet a go-it-slow approach could leave him empty-handed, given the pace of competition for the red-hot Hispanic media market, whose audience of 40 million in the U.S. has an estimated \$650 billion



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A photograph of a modern building at night. The building features a series of vertical columns and large windows, some of which are illuminated from within. The sky is dark blue. The text "WHY DO WE WORK?" is overlaid in the center in a bold, white, sans-serif font. The foreground shows a parking lot with white lines.

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in buying power. Aggressive players such as Telemundo Communications Group Inc., owned by media giant NBC Universal, are moving in, too. Two years ago, NBC paid \$2.7 billion for Telemundo and is investing \$150 million annually in programming. "Telemundo is a growing threat," acknowledges Televisa executive vice-president Alfonso de Angoitia. Televisa's programs are the "oxygen" for Univision, Telemundo President James McNamara says, "clearly for us the competition is Televisa...not Univision." And even TV Azteca, Mexico's distant No.2 network, stepped in three years ago with its fledgling U.S. network, Azteca América. Two years ago, Viacom made an offer for Univision but was rebuffed.

THE BIG PRIZE

EVEN AS HE DANCES gingerly with Univision, of which Televisa owns 10.7%, Azcárraga has teamed up with another entertainment giant, Clear Channel Communications Inc., based in San Antonio, which has said it's interested in making a bigger push into Hispanic radio. In a joint venture, Televisa and Clear Channel stage live sports and entertainment ventures aimed at Hispanics. It costs little to bring up the three soccer teams Televisa owns or its star actors for live events with big sponsorships. Last year they staged 80 shows in the U.S., and they'll do around 150 this year.

To help scout opportunities, Azcárraga, sitting on \$1 billion in cash at Televisa, has a tight group of trusted advisers, including Bernardo Gómez, 37, a high school friend who oversees Televisa's news programming, sales, and planning, and de Angoitia, 41, architect of Televisa's financial restructuring.

But for all the smallish deals, Univision, with its 70% market share among U.S. Hispanics, is still the big prize. Azcárraga knows that Perenchio, who bought the company in 1992 with Azcárraga's father, Emilio Azcárraga Milmo, and with Gustavo A. Cisneros, chairman of Venezuelan network Venevisión, has no intention of relinquishing control, at least for now. What's more, Televisa is in no position to launch a bid now, its executives say. Although it earned \$320 million on \$2.1 billion in 2003 revenues, vs. Univision's \$155 million in profits on \$1.3 billion in sales, Televisa's market cap of around \$6.8 billion falls short of Univision's \$11.1 billion. "For the time being, it doesn't make a lot of sense for Televisa shareholders to think about doing a combination with Univision, be-

Pursuing an American Dream

Mexico's Televisa, the \$2.1 billion Spanish-language media company, is making a big push across the U.S. border. CEO Emilio Azcárraga's strategy:

WHY Azcárraga wants to tap into fast-growing U.S. Hispanic market, with its \$650 billion in buying power, which would build on his 10.7% equity share of No. 1 U.S. Hispanic broadcaster Univision.

HOW Televisa has begun boosting its U.S. presence through live sports and entertainment events, largely through a partnership with San Antonio-based radio giant Clear Channel Communications, and through magazine and book publishing. Down the road, Azcárraga could seek U.S. citizenship so he can control a broadcasting group, perhaps Univision.

Data: BusinessWeek

cause [their ownership] would be diluted," says de Angoitia.

Still, Azcárraga is focused on improving relations with Perenchio after years of feuding. He became vice-chairman of Univision's board and regularly dines with Perenchio, who at 73 is twice his age. Perenchio, unable to attend Azcárraga's Mexico City wedding in February, hosted a dinner for the newlyweds at his Beverly Hills mansion in May.

What makes Azcárraga think Televisa can stay on top? "Televisa's advantage is that it has the content," he says. By owning distribution in the U.S., such as a broadcast network or local TV stations, Televisa would have greater leverage yet. Still, Azcárraga insists he's in no rush to become a U.S. citizen. He's not yet ready to disrupt his family life to spend half his time in the U.S. for five years to qualify, he says. If he sees another competitor moving in for the kill, though, he wouldn't hesitate to move full-time into his South Beach Miami apartment. But for now, he's invading Hispanic America, one deal at a time. ■

—By Geri Smith in Mexico City

BusinessWeek online

For excerpts from interviews with Emilio Azcárraga, go to www.businessweek.com/magazine/extra.htm

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P&G Has Rivals In a Wringer

Colgate and Unilever are hurting as it rolls out creative products and marketing

THESE ARE TOUGH TIMES for the consumer-products industry. Raw-material costs are soaring even as big retailers demand ever-lower prices for the toothpaste, diapers, and dishwashing detergent they peddle. So it was perhaps not so shocking when, on Sept. 20, both Colgate-Palmolive Co. and Unilever Group sharply reduced earnings forecasts for the second half of the year. What is surprising is how nimbly industry giant Procter & Gamble Co. seems to be navigating the same shoals.

Not so very long ago, P&G was the lumbering giant of the industry. No longer. Thanks to a potent mix of smart products and muscular marketing, it is thriving at a time when others are sputtering. Quarterly earnings are expected to rise 14% when P&G reports in October, vs. an expected 7.7% drop at Colgate. Unilever has also said its upcoming quarterly profit will fall below the year ago level. And P&G continues to gain share in lucrative spots: It has 70% of the tooth-whitening market, up from 57% a year ago, and 48% of disposable diapers, vs. 45% a year ago.

What does P&G have that others lack? Size, of course. With \$51 billion in sales last year, P&G is about five times larger than Colgate. It has also been smart about targeting



higher-margin areas, such as beauty care, that require less capital spending than its traditional businesses, such as disposable diapers. That has freed up more dollars to spend on advertising. P&G's ad budget is now 10.7% of sales—up from 8.1% in 2001 and double the percentage Colgate spends.

But the real key for P&G has been renewed creativity. Since A.G. Lafley took over in 2000, P&G has shown a savvy knack for innovation. From its Swiffer mop to battery-powered Crest SpinBrush toothbrushes and Whitestrip tooth whiteners, P&G has simply done a better job than rivals at coming up with new products that consumers crave—and, not incidentally, on which it can earn higher margins than it can on its more mature lines. In the last three years P&G has updated all of its 200 brands and created whole new product categories—such as Mr. Clean AutoDry Carwash—

that have added \$2 billion in sales. “We are growing market share in 70% of our businesses,” says Clayton C. Daley Jr., P&G's chief financial officer. “That doesn't happen unless you have strong innovation.”

More aggressive marketing helps, too. Check out P&G's latest take on toothpaste-hawking: The company is launching its Crest Vanilla Mint toothpaste during an episode of *The Apprentice*. The focus of the show will be the contestants plans for marketing the toothpaste. During a 15-second spot, viewers will be invited to visit Crest.com, where they can write in how they would have handled the marketing job. The winner will get a free trip to the live show finale.

Just as important, P&G is becoming expert at stealth marketing. When it was developing Whitestrips, it held off on expensive TV ads and store testing,

opting instead for a six-month online ad and sales campaign. That allowed execs to gauge interest and refine the marketing. “It was inexpensive,” says Gary M. Stibel, founder and principal at New England Consulting Group. “And by the time they were ready to launch, they had a huge head start.”

BLOCKBUSTER
P&G has 70% of the tooth-whitening market

Rivals, too, are stepping up their marketing. But without innovative new products to match, that effort could devolve into a round of discounting, some warn. “They run the risk of having the brands fall to the point where they're not even relevant to the consumers unless they're on sale,” says Alfred A. Davis, former manager for new-business development at P&G and now director of national accounts at a food-service supply company.

Of course, none of this guarantees that the same economic forces that are buffeting Colgate and Unilever won't start to pinch P&G, too. And Colgate and Unilever are hardly down for the count. “There is a worldwide competitive threat, and we have learned from long experience that you must deal with it immediately and forcefully, and then you emerge stronger afterwards,” says Colgate CEO Reuben Mark.

Maybe so. But given P&G's current advantages, the smart money is betting on the company that suddenly made the world need brighter, whiter teeth. ■

—By Robert Berner in Chicago, with Nanette Byrnes in New York and Wendy Zellner in Dallas

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The World of Golf



The Ryder Cup: Oakland Hills Country Club – Taming “The Monster”

Oakland Hills Country Club in Bloomfield Hills, Michigan, has a long and distinguished history. The course was designed by Donald Ross, and was formally opened in July 1918 with one of the country's greatest golfers as its first professional in the form of Walter Hagen, who had won the US Open in 1914 and would win it again in 1919. But the prestigious club, which is located some 30 miles from Detroit's Metro Airport, has waited a long time to host its first Ryder Cup. If previous encounters contested by the world's finest golfers on its Championship South course are anything to go by, however, the wait will have been worthwhile.



As well as a number of PGA Championships, US Seniors and other competitions, those contests have included six US Open Championships. The first, held in 1924, was won by Cyril Walker, while the most recent – in 1996 – saw a young Tiger Woods celebrating his last major as an amateur by finishing a creditable 16 strokes (14 over par) behind the winner, Steve Jones.

By far the most memorable US Open to have been staged at Oakland Hills, however, was the 1951 Championship which was responsible for giving the course a nickname that it has retained ever since. In their

battle that year against Oakland Hills' notoriously perilous greens, only two players shot sub-par rounds, with Ben Hogan's final card of 67 taking him to the third of his four US Open victories. Commenting on the match afterwards, Hogan was quoted as saying "I am glad I brought this course, this monster, to its knees." He also observed that Oakland Hills was "the greatest test of golf" and the "most challenging course" he had ever encountered.

Of all the golfers to have pitted their wits against Oakland Hills' monstrous challenges over the last five decades, none would validate Hogan's famous judgement as readily as the unfortunate T.C. Chen. In the US Open in June 1985, Chen took a four-stroke lead into the final round, only to see his hopes evaporate long before he reached the so-called "fearsome fivesome" at the end of the course. A disastrous quadruple bogey on the fifth prevented an unlikely Taiwanese triumph – which would have been the first and only victory by an Asian golfer at the US Open.

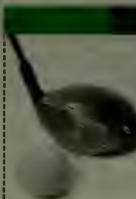


"I am glad I brought this course, this monster, to its knees."

Ben Hogan,
Ryder Cup winner 1951



If the teams led by Hal Sutton and Bernhard Langer find the course chosen for the 35th Ryder Cup uncomfortable, it is unlikely that they will level the same challenges at the Oakland Hills facilities. Extensive refurbishments to the clubhouse were made in the late 1960s, and more recently, a \$16.25m renovation project was implemented at the start of 1999, helping Michigan's premier golf club to strengthen its credentials as one of America's finest.



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COVER STORY



FUZZY NUMBERS

**DESPITE THE REFORMS, CORPORATE PROFITS
CAN BE AS DISTORTED AND CONFUSING AS
EVER. HERE'S HOW THE GAME IS PLAYED.**

BY DAVID HENRY

CONSTRUCTION GIANT AND MILITARY contractor Halliburton Co. did something mind-boggling last year: It reported earnings of \$339 million, even though it spent \$775 million more than it took in from customers. The company did nothing illegal. Halliburton made big outlays in 2003 on contracts with the U.S. Army for work in Iraq—contracts for which it expected to be paid later. Still, it counted

some of these expected revenues immediately because they related to work done last year. Investors didn't get the full picture until six weeks later, when the company filed its complete annual report with the Securities & Exchange Commission. Halliburton says it followed generally accepted accounting principles (GAAP).

Maybe so, but after three years of reforms in the wake of corporate scandals, the Halliburton case illustrates that earnings remain as susceptible to manipulation as ever. Why? Because accounting rules give companies wide discretion in using esti-

mates to calculate their earnings. These adjustments are supposed to give shareholders a more accurate picture of what's happening in a business at a given time, and often they do. Bean counters call this accrual accounting, and they have practiced it for decades. By accruing, or allotting, revenues to specific periods, they aim to allocate income to the quarter or year in which it was effectively earned, though not necessarily received. Likewise, expenses are allocated to the period when sales were made, not necessarily when the money was spent.

The problem with today's fuzzy earnings numbers is not accrual accounting itself. It's that investors, analysts, and money managers are having an increasingly hard time figuring out what judgments companies make to come up with those accruals, or estimates. The scandals at Enron, WorldCom, Adelphia Communications, and other companies are forceful reminders that investors could lose billions by not paying attention to how companies arrive at their earnings. The hazards were underscored again Sept. 22 when mortgage-finance giant Fannie Mae said its primary regulator had found that it had made accounting adjustments to dress-up its earnings and, in at

least one case, achieve bonus compensation targets. The company said it is cooperating with government investigators. The broader concern is that corporate financial statements are often incomplete, inconsistent, or just plain unclear, making it a nightmare to sort out fact from fantasy. Says Trevor S. Harris, chief accounting analyst at Morgan Stanley: "The financial reporting system is completely broken."

Indeed, today's financial reports are more difficult to understand than ever. They're riddled with jargon that's hard to fathom and numbers that don't track. They're muddled, with inconsistent categories, vague entries, and hidden adjustments that disguise how much various estimates change a company's earnings from quarter to quarter, says Donn Vickrey, a former accounting professor and co-founder of Camel-

Income, balance sheet, and cash flow statements are out of sync with one another

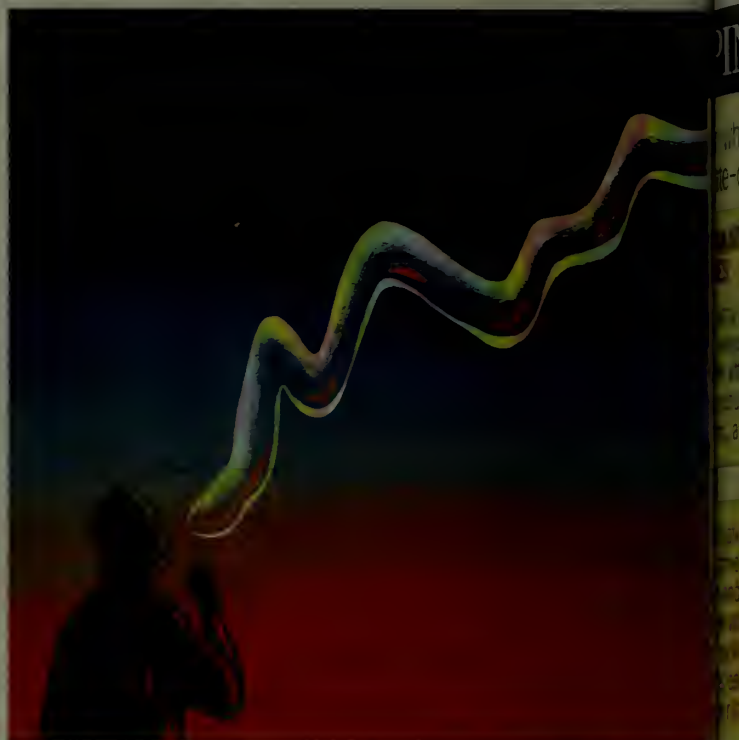
back Research Alliance Inc., a Scottsdale (Ariz.) firm hired by institutional investors to detect inflated earnings.

The upshot: The three major financial statements—income, balance sheet, and cash flow—that investors and analysts need to detect aggressive accounting and get a full picture of a company's value are out of sync with one another. Often, the income and cash-flow statements don't even cover the same time periods. "A genius has trouble trying to get

them to tie together because different items are aggregated differently," says Patricia Doran Walters, director of research at CFA Institute, the professional association that tests and certifies financial analysts. "You have to do an enormous amount of guessing to even come close."

Many of the reforms adopted by Congress and the SEC will not remedy the situation. Most are aimed at policing the people who make the estimates rather than the estimates themselves. And some changes have yet to go into effect. No doubt, chief executives and auditing committees are paying closer attention to the numbers, and accounting experts believe there are fewer instances these days of outright fraud. But that's to be expected in a stronger economy. The big question is whether increased scrutiny is yielding more realistic estimates or just more estimates documented by reams of assumptions and rationalizations. We'll only know the answer when the economy begins to falter and corporate earnings come under pressure.

Already, recent academic research suggests that the abuse of accrual accounting is pervasive across a broad swath of



companies. And it's enough to goad Wall Street into action. Aware that executives have tremendous opportunity to manipulate the numbers through their estimates, the market is on alert, delving more vigorously than ever into the estimates that go into compiling earnings. Over the past two years, investment banks have beefed up their already complex computer programs to screen thousands of companies to find the cheerleaders who make very aggressive estimates.

As analysts and investors drill deeper into these financials, they're finding some nasty surprises. Accounting games are spreading beyond earnings reports as some companies start to

PUMPING UP THE CASH

Analysts used to believe that cash is a fact and earnings an opinion. Now they're discovering how accounting rules allow companies to massage the presentation of their cash positions, too. Here's what a company can do:

TRADE SECURITIES	FREE UP WORKING CAPITAL	SELL RECEIVABLES	TURN TRADE CREDIT INTO CASH
Company designates certain stocks or money market accounts it holds as trading instruments	Company cuts inventories, delays payments to suppliers, and leans on customers to pay faster	Company sells customer IOUs for less than face value, booking the cash immediately instead of waiting for customers to pay	Company lends money to customers to buy products; resulting count as cash from operations, with loan shown as investment
EFFECT			
Inflates operating cash flow when the securities are sold; masks the volatility of the business	Raises cash flow from operations, but tends to hurt future growth; often reversed in later quarters, depressing cash flow	Gives cash flow from operations a one-time lift; reduces amount of cash company ultimately receives	Boosts operating cash flow with company's own money; encourages risky lending practices

SPINNING THE EARNINGS

When playing strictly by the book, companies have many ways to inflate—or deflate—the earnings they report. Here's how:

ESTIMATE ES	PREDICT BAD DEBTS	ADJUST INVENTORY	FORECAST UNUSUAL GAINS OR LOSSES
Many estimates of revenues it will receive after allowing for discounts, product returns, and the like	As it sends out bills, company figures how much it will lose on customers who don't pay	Company underestimates how much inventory will become obsolete	Company predicts special costs, such as restructurings or special gains
EFFECT			
Optimistic treatments inflate earnings; conservative ones act like a cookie jar that saves earnings for later times	Understating bad debts lowers operating expenses and raises earnings; overstating bad debts gives profits a lift when the estimates are reversed	Lowballing losses on inventory overstates current profits and hurts future results when inventory is finally written off	Overestimating one-time expenses cuts earnings now, but banks them for the future; overestimating gains boosts profits, but sets up a potential earnings hit later

play fast and loose with the way they account for cash flows. That's a shocker because investors always believed cash was sacrosanct and hard to trump up. Now they're discovering that cash is just as vulnerable to legal manipulation as earnings. Companies from Lucent Technologies Inc. to Jabil Circuit Inc. have boosted their cash flow by selling their receivables—what customers owe them—to third parties. Says Charles W. Mulford, accounting professor at Georgia Tech's DuPree College of Management and author of an upcoming book on faulty cash reporting: "Corporate managers, knowing what analysts are looking at, say: 'Let's make the cash flow look better.' So the

game goes on." A Lucent spokesman says it sells receivables to raise cash more cheaply than it could by borrowing the money. Jabil did not respond to questions.

Even with Wall Street's heightened scrutiny, many pros think the situation won't improve anytime soon—and it may well get worse. That's because accounting standard-setters at the Financial Accounting Standards Board (FASB) are deep into a drive to require companies to make even more estimates—increasing the potential for further manipulation of their bottom lines. One example: It's requiring companies to estimate changes in the value of a growing list of assets and liabilities, including trade names and one-of-a-kind derivative contracts. Eventually,

companies will have to make corresponding adjustments, up or down, to their earnings.

There's some logic in FASB's position. It wants to improve the way changes in the value of corporate assets are reflected in financial statements because they can have a significant impact on a company's value. FASB argues the new estimates should be reliable since many will be based on known market prices. Unfortunately, others will rest on little more than educated guesses that in turn depend on a lot of other assumptions. "When you do that, you reduce the reliability of the numbers, and you open up the doors to fraud," says Ross L. Watts, accounting professor at the William E. Simon Graduate School of Business Administration at the University of Rochester.

FASB is understandably gun-shy about imposing even more rules on businesses. It has spent the last three years, and lots of political capital, trying to put in place requirements to expense the cost of stock options and to limit off-balance-sheet arrangements. But it has come up short by not insisting on financial statements that show in a simple way what judgments have gone into the estimates. FASB Chairman Robert H. Herz doesn't feel any urgency to do so. He argues that investors and analysts aren't yet using all the information they now have. Besides, he adds, he doesn't want to pile too many new requirements on companies. After the recent reforms, Herz says: "Right now, [they] are very tired."

Tired, maybe, but not tired enough to renounce numbers games. Even among execs who wouldn't dream of committing fraud, there are plenty who are ready to tweak their numbers in an effort to please investors. In a Duke University survey of 401 corporate financial executives in November, 2003, two out of five said they would use legal ways to book revenues early if that would help them meet earnings targets. More than one in five would adjust certain estimates or sell investments to book higher income. Faulty accounting estimates by execs caused at least half of the 323 restatements of financial reports last year, according to Huron Consulting Group.

The cost of this obfuscation is high. According to studies of 40 years of data by Richard G. Sloan of the University of Michi-



gan Business School (page 88) and Scott Richardson of the University of Pennsylvania's Wharton School, the companies making the largest estimates—and thus reporting the most overstated earnings—initially attract investors like moths to a flame. Later, when the estimates prove overblown, their stocks founder. They lag, on average, stocks of similar-size companies by 10 percentage points a year, costing investors more than \$100 billion in market returns. These companies also have higher incidences of earnings restatements, SEC enforcement actions, and accounting-related lawsuits, notes Neil Baron, chairman of Criterion Research Group, a New York researcher where Richardson consults. "Given the pressure on executives to reach expected earnings, it is not surprising," says Baron.

That's why more portfolio managers are using sophisticated screening to identify companies that make aggressive estimates and those that don't. Sloan and Richardson discovered that if you had sold short the companies with the biggest estimates and bought those with the smallest, you would have beaten the market 37 out of 40 years and by a huge margin—18 percentage points a year before trading costs. Now, Goldman Sachs Asset

Here are some of the ways companies can legally use accounting rules to inflate—or deflate—the earnings and cash flow they report:

ESTIMATE SALES With the stroke of a pen, companies can use estimates that make it appear as though sales and earnings are growing faster than they really are. Or, if they fear lean times ahead, they can create a cookie jar of revenues they can report later. Hospital companies, such as Health Management Associates Inc., report revenues after estimating discounts they will give to insurers and for charity cases. These discounts are typically two-thirds of list price, so a slight change in what HMA figures they will cost could have a large impact on its income. Vice-President for Financial Relations John C. Merriwether says the company uses conservative estimates.

Getting the revenue right isn't easy. Computer software vendor IMPAC Medical Systems Inc. says three different auditors gave differing opinions on when it could count revenue from certain contracts that included yet-to-be-delivered products. Its latest auditor, Deloitte & Touche, resigned just 10 weeks into the

job after declaring that the company had counted revenue from 40 contracts too soon. IMPAC Chairman and CEO Joseph K. Jachinowski says he's asking the SEC how to book the contracts.

PREDICT BAD DEBTS

How companies account for customers' bad debts can have a huge impact on earnings. Each quarter they set aside reserves for loan losses—essentially guesses of how much money owed by dead-

beats is unlikely to be paid. The lower the estimate, the higher the earnings. On July 21, credit-card issuer Capital One Financial Corp. reported quarterly results that would have been 3¢ a share below Wall Street estimates had it not reduced its reserves, says David A. Hendler, an analyst at researcher CreditSights. Capital One CFO Greg L. Perlin says the company made the change because it is lending to more credit-worthy customers now.

Sometimes companies on opposite sides of the same deal use different estimates. An example: Reinsurance companies have

reserves of about \$104 billion to pay claims they expect from property-and-casualty insurers. But the P&C insurers have booked \$128 billion in payments they expect to receive from the reinsurers, according to Bijan Moazami, an insurance-industry analyst at Friedman, Billings, Ramsey Group Inc. He says the property-and-casualty companies will cut earnings as it becomes clear they won't collect all the money. Hartford Financial Services Group Inc. and St. Paul Travelers Cos. took such charges this spring, of \$118 million and at least \$164 million after taxes, respectively. The Hartford said it acted after reviewing its reinsurance arrangements.

THE HIGH-RISK EARNINGS GAME

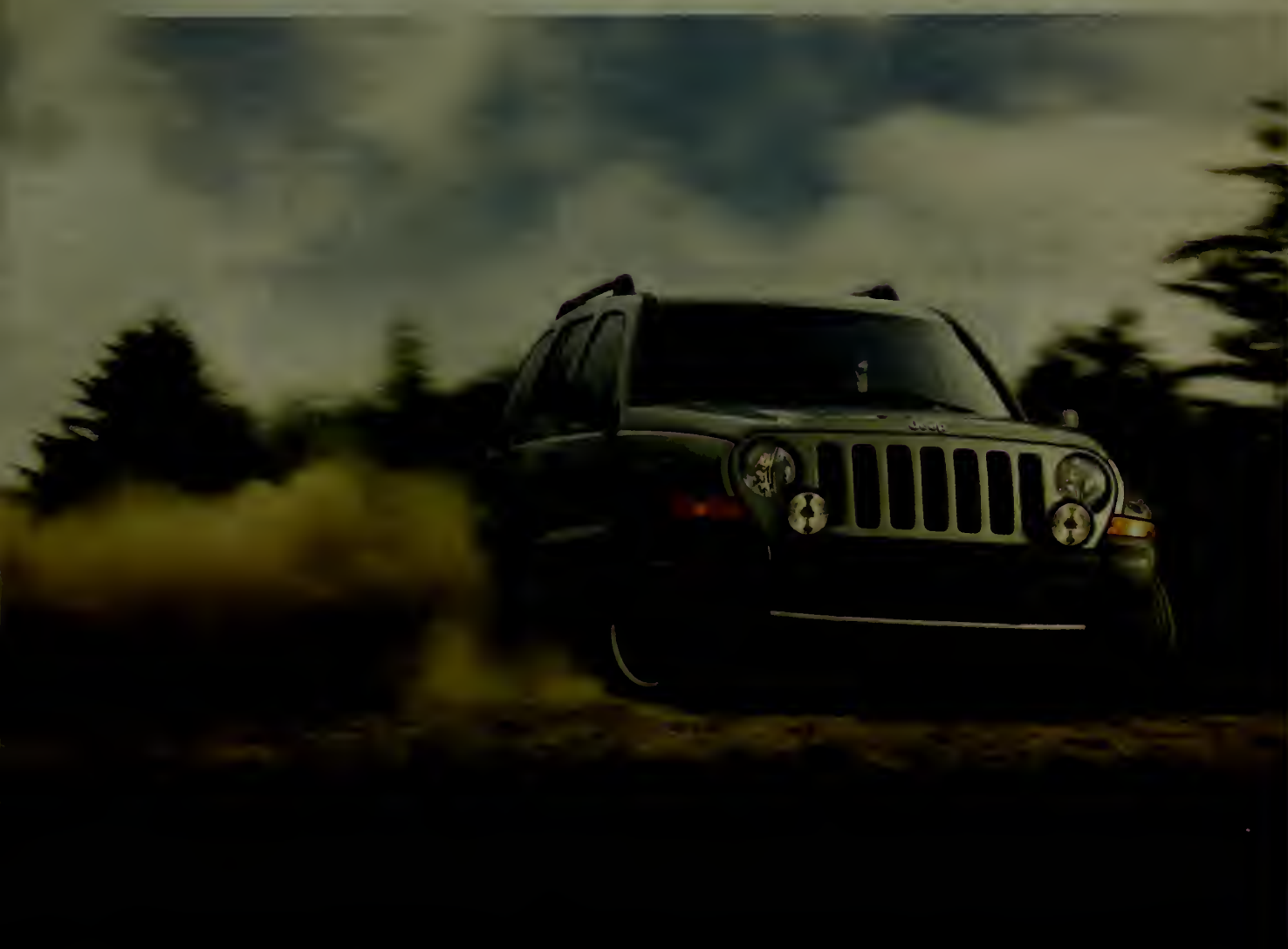
Companies with the highest accounting estimates get an outsized lift to earnings, attracting analysts and investors. But once the estimates peak (shown as year 0 in the charts), bad things start to happen very quickly:



Management, Barclays Global Investors, and Susquehanna Financial Group, among others, are employing versions of the Sloan-Richardson models to guide their investments. Strategists at brokerages, including Sanford C. Bernstein Research, Credit Suisse First Boston, and UBS have built model portfolios using similar techniques.

Others on Wall Street seek an edge by going even further: They're deconstructing and rebuilding companies' financial reports. Morgan Stanley's Harris recently led an 18-month project aimed at filtering out the effects of accounting rules that can distort results from operations. His team gathered some 2.5 million data points and held countless discussions with analysts of individual companies. In an early test, the exercise determined that Verizon Communications Inc.'s pretax operating profit in 2003 was \$13.7 billion rather than the \$16.2 billion Morgan Stanley's star telecom analyst had first calculated using GAAP. That's mainly because GAAP allows companies to include estimates for what their pension plans will earn as current profits. A Verizon spokesman said the company has been careful to disclose its assumptions and tell investors how much its pension accounting boosts earnings.

Estimates—of pension-fund profits, unpaid receivables, old inventory—are easy to manipulate



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A St. Paul Travelers spokesman says: "We are comfortable with our estimates."

ADJUST INVENTORY By changing the costs they estimate for inventory that will be obsolete before it can be sold, companies can give their earnings a substantial boost. Vitesse Semiconductor Corp. took inventory expenses of \$30.5 million in 2002 and \$46.5 million in 2001. In 2003, it took no expenses but wrote off \$7.4 million against a previously established reserve for obsolete inventory. Had it not tapped its reserves, the \$7.4 million would have come out of current earnings, notes Terry Baldwin, an accounting analyst at researcher Glass Lewis & Co. Instead, Vitesse was able to report earnings of about 2¢ a share more than it could have otherwise. Vitesse's vice-president for finance, Yatin Mody, says the company properly counted the costs in 2002 when it foresaw that the goods were likely to become obsolete because of the telecom bust.

Inventory accounting can produce even more bizarre outcomes. Last year, General Motors Co. reported an extra \$200 million in pretax income after using up more inventory than it replaced. In standard last-in, first-out inventory accounting, when the older and less costly goods are sold at today's prices, profits look better. But GM's future earnings could be hit if it needs to replace inventory at higher prices. GM says it properly applied accounting rules to its inventory management.

FORECAST UNUSUAL GAINS OR LOSSES The ability to time big and unusual gains or expenses can give companies plenty of control over their numbers. For 2003, Nortel Networks Corp. reported an earnings rebound when it reversed a portion of the \$18.4 billion in charges it had logged for restructuring costs, bad customer debts, and obsolete inventory in the preceding three years. But last Apr. 28, the company said it "terminated for cause" its chief executive, its chief financial officer, and its controller amid an ongoing review and restatement of financial reports. In August, Nortel said it had fired seven more finance officers. Now the company says it had paid out \$10 million in executive bonuses based on the trumped-up rebound. Nortel's new managers say they're trying to get the money back and that an independent panel "is examining the circumstances leading to the requirement for the restatements."

MESSAGE CASH Because analysts and investors are focusing on cash flow from operations as an indicator of financial health, those numbers are now a prime target for massaging. Companies have had to report cash flows since 1988, classifying them into one of three categories: operating, investing, and financing. By exploiting loopholes in GAAP rules, they can make their operating cash look a heap better. For example, in their consolidated financial statements, Boeing, Ford, and Harley-Davidson count as cash from operations the proceeds of sales of planes,

The way cash flows are being finessed is as worrisome as '90s dot-com earnings were

cars, and bikes that customers bought with money they borrowed from the companies wholly owned finance subsidiaries. As a result, cash from operations is higher, even though the companies didn't rake in any more of it. In a quarter through March, Boeing Co. reported \$268 million in cash from operations that actually reflected what the company classified as investments by Boeing Capital Corp. in loans to customers to buy aircraft. Without the transactions, Boeing would have reported a \$363 million drain of operating cash. For all of 2003, such transactions contributed \$1.7 billion of Boeing

\$3.9 billion in operating cash. The company says it has been preparing its accounts this way for years, and the method conforms to GAAP rules. Boeing began disclosing the amount in a footnote in mid-2002. Harley-Davidson Inc. Treasurer James M. Brostowitz says its loans are properly disclosed, and analysts can make adjustments as they see fit. A Ford spokesman says the company's accounting complies with GAAP and accurately reflects its business.

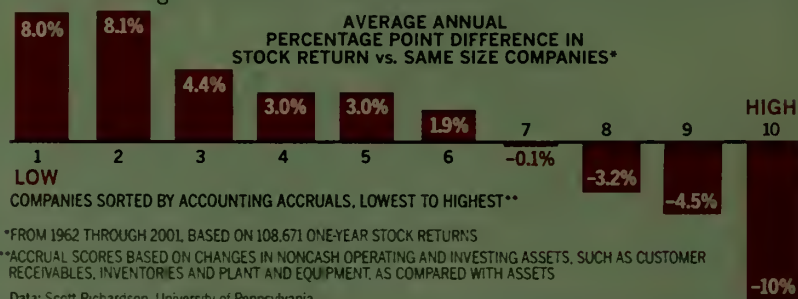
The simplest way for companies to pump up their cash is to sell what customers owe them to a third party. Increasingly, companies carve out these receivables from their most creditworthy customers, sell them at a discount, and then present the move as smart capital management that boosts liquidity. Such deals give analysts fits because they are really financing actions. Jabil Circuit sold some receivables in an arrangement with a bank in the two quarters ended in May. That added \$120 million, or nearly half of the \$275 million of operating cash flow it reported in the period. But Jabil had to sell its re-

ceivables at a discount and recognize \$400,000 loss. The company did not provide comments after repeated requests.

Some transaction just keep operating cash flows looking pretty. Companies can use excess cash to buy securities when business is booming and then harvest it by selling them when the business runs cold. In 2003, Ohio Art Co., the tiny maker of Etch-A-Sketch drawing

BIG ESTIMATES, SMALL RETURNS

It pays for investors to know the extent to which managers make accounting estimates in their reported earnings. The reason: In 37 out of 40 years, stock returns were higher for those with low estimates.



toys, used cash from operations to buy \$1.5 million worth of money market funds. It sold them this year, boosting cash flow. CFO Jerry D. Kneipp says the company relied on its auditors in reporting the transactions. Cable company Comcast Corp. reported \$85 million in additional operating cash flow in 2003 from sales of securities. Though this move was by the book, it distorted cash flow from operations. Comcast says that before 2002 it counted such proceeds as cash from investments. It changed the way it reports such deals to meet a 2002 FASB standard.

Mergers, too, can cloud the numbers. Consider again the HMA hospital chain. It regularly has a higher ratio of receivables to sales than do its peers—a red flag to analysts because it might be a sign that a company is booking more revenues than it will ever collect. But HMA's Merriwether says the high receivables are explained largely by its steady acquisitions of hos-

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Moderator

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pitals, about four a year. With each deal, it has to submit new paperwork to the government and private insurers and wait weeks before they will pay new patients' bills, he says. With a continuous flow of deals, says Sheryl R. Skolnick, an analyst at Fulcrum Global Partners who has recommended selling HMA's stock, "you have no idea what is going on."

One of the quickest, but most fleeting, ways companies can increase cash flow is to shrink their working capital. That can include selling off inventory, pressuring customers to pay quickly, and stalling payments to suppliers. While executives often claim that these moves make the company increasingly powerful and profitable, the opposite may actually be the case. General Dynamics Corp., for example, boasts in its 2003 annual report that it "has proven itself an industry leader in generating strong cash flows, which have enabled it to enhance returns through strategic and tactical acquisitions and share repurchases." Cash generation was "particularly strong" in 2003, it said. But while cash flow from operations rose to \$1.7 billion from \$1.1 billion the year before, half of the improvement came from slashing inventories in 2003 after adding to them in 2002. While cutting inventory may make sense given the weakened market for planes, it was a one-time cash boost from downsizing a business, not a sign of strong future cash flows. A company spokesman notes that Chairman and CEO Nicholas D. Chabreja told analysts in January that while General Dynamics' cash flow may fluctuate from year to year, it has tracked earnings over the past five years, even as the company was investing for growth in other areas.

The way companies are spinning their cash flows looks to some analysts as worrisome as the press releases announcing "pro-forma" earnings that companies cultivated during the 1990s tech-stock bubble. General Motors, for example, boasted in a Jan. 20 press release that it had "generated" \$32 billion in cash in 2003. "That's outrageous," says Marc Siegel, a senior analyst at the Center for Financial Research & Analysis. GM had actually borrowed about half of that money by issuing bonds and convertible securities. The auto maker says it had explained publicly the steps it was taking to get that cash number.

Concentrating too much attention on short-term cash flows can have significant effects. It could discourage companies from making investments that could add to economic growth and boost returns on capital. "They are routinely saying 'no' to valuable projects," laments Campbell R. Harvey of Duke University's Fuqua School of Business. Some stocks, such as Computer Sciences Corp., now tend to move up when they report higher

"free cash flow," a measure that looks better when companies scrimp on capital investments. CSC declined to comment. The danger, warns Morgan Stanley's Harris, is that "we can end up inducing people to make wrong economic decisions for appearance purposes. Then the investor will lose." Indeed CFOs' desire to show high free-cash flow may be one reason corporate investment is now far below average.

THE SOLUTIONS For now, investors are left largely to their own devices to make sense of companies' numbers. Auditors—the first line of defense against financial shenanigans—are under scrutiny by a new oversight board, which is rewriting audit standards. Other accounting reforms have yet to take effect. The requirement in the Sarbanes-Oxley Act of July, 2002, which compels executives and directors of big companies to establish internal controls on bookkeeping and valuations underlying financial reports, won't be in full force until next year. And while the SEC's Corporation Finance Div. has started prodding companies to disclose more of their critical accounting estimates in public filings, the results so far are spotty, and many disclosures are buried in dense text. FASB is talking about revamping the income and cash-flow statements, but not for at least a couple of years.

There's plenty that regulators could do now to improve the quality of financial information. FASB should put aside some of its less pressing projects and turn its full attention to making it easier for investors to get behind companies' earnings numbers. If the form and presentation of financial statements were cleaner and more consistent, investors would be better able to spot accounting tricks. For example, earnings statements could be recast to distinguish between profits that come from selling products from those that come from ever-changing estimates. "You want to understand the subjectivity involved in these different numbers," says the CFA Institute's Walters.

The statement of cash flow needs a lift, too. Regulators must change the mirror-image presentation in which increases in cash show up as negative numbers and decreases as positive. They also have to define more clearly what constitutes an operating, investing, or financing item.

And FASB should make it easier for investors to make reliable comparisons. An obvious and simple step would be for companies to present their statements of cash flows for the same periods as their earnings statements. Even better would be to show the cumulative earnings and cash flows for the previous four quarters as well. Now most companies simply compare the latest quarter's earnings with those for the same quarter a year be-



LIFTING THE FOG

Companies could help investors by showing clearly the estimates and judgments they make in reporting earnings. Here's what they need to do:

- Overhaul the statement of cash flow to keep transactions from investing and financing separate from operating cash.
- Redo the income statement to break out operating results from estimated changes in the value of assets and liabilities.
- Report income and cash flow for the same time periods; give comparable results for the previous four quarters.
- Show changes in important accounting estimates in easy-to-read tables each quarter.
- Use the same categories and terminology in quarterly reports so that each item can be compared over time.



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fore, but present a year-to-date statement of cash flows without a comparison. Many financial analysts rearrange company data to highlight meaningful comparisons, but they have to build special spreadsheets for the task, and they need a library of past reports to feed into them. Companies should also clearly display in tables—not just in text—the changes they make in reserves.

With better and more consistent information in financial statements, investors would be able to reward and punish companies based on the quality of their accounting. “Then [investors] would start providing some discipline by dis-

counting stocks when they aren’t sure what the numbers are going to be,” says Lynn E. Turner, a former SEC chief accountant and now research director at Glass Lewis. What’s more, auditors would be on increased alert knowing that investors are looking over their shoulders.

Because companies will be using even more estimates in the future, they’ll have even more opportunities to hype their results. To avoid future blowups, investors need a clear picture of a corporation’s finances. Investors shouldn’t have to wait for another Enron for regulators to tackle these issues. ■

A MARKET SCHOLAR STRIKES GOLD

As an accounting professor at the University of Michigan, Richard G.

Sloan was happy to receive a call inviting him to speak to a couple of hundred top institutional investors in New York City. Trouble was, Sloan was going to be on sabbatical in Western Australia when the conference was held in March. So Bernstein Research, the conference sponsor, flew him back—in business class.

Such is 39-year-old Sloan’s star power now that a Wall Street firm will hire him to travel 30 hours to give a one-hour talk and chat with some clients. His acclaim is founded on a paper he published in 1996 in a tiny journal, *The Accounting Review*. Using decades of data, Sloan was the first to find that investors habitually overlook the role accounting estimates play in determining a company’s earnings and hence its stock performance. He sorted through clues in the financial reports and came up with the 10% of companies using the biggest estimates and the 10% using the smallest. His discovery, now known as the accrual anomaly, revealed that companies routinely using the highest estimates had stock prices most likely to fall, while those with the lowest tended to rise.

The market’s inability to detect this pattern means that big money is left on Wall Street trading floors. How much? Well, if you had sold short the basket of stocks with



SLOAN Investors put too much faith in reported earnings

evaporating earnings while buying the 10% on the rise, you would have beaten the market, before trading costs, by an average of 18 percentage points a year from 1962 to 2001, Sloan figures. Now investors are clamoring to exploit this market inefficiency. “They seem to be in a bit of a frenzy about it,” he says.

It wasn’t always so. For years, Sloan didn’t get much credit for his insight. Academics didn’t believe the market would consistently miss the relationship between estimates and stock price. Sloan even doubted it himself when he first ran the numbers in 1991. Then, the reigning view was that markets efficiently use all available financial information to determine a stock’s worth. “I thought I must have done something wrong,” he says.

He checked and rechecked the numbers. Then he submitted his paper to an academic journal four times in five years, only to have

it returned each time with questions and suggestions for investigation. He finally sent the paper to *The Accounting Review*, which accepted it on his second try. Even so, Sloan was almost apologetic about his results in the article’s conclusion. “He was still kind of keeping the door open for efficient markets even though he had discovered this

anomaly,” says Bruce A. Gulliver, president of Jefferson Research & Management, a Portland (Ore.) firm that uses Sloan’s analysis in its stock research and investing.

Doubters among his peers persisted. “A very large number of papers followed up to check on him,” says Charles M.C. Lee, a Cornell University accounting professor now on leave to help Barclays create portfolios using Sloan’s ideas. “It is not a statistical fluke.” The big accounting scandals proved Sloan was right: Investors had put too

much trust in reported earnings.

Debate continues over why this anomaly occurs. Some scholars think it’s less a matter of earnings manipulation and lazy investors than executives trying to grow their companies too fast and investors going along. Sloan and a colleague, Scott Richardson at the University of Pennsylvania, have concluded that growth isn’t the big factor. They say the primary blame lies, if not with manipulation, with the hubris of executives and investors who want to believe that their assumptions will drive the stock higher.

Whatever the cause, Sloan and others say there’s still money to be made. But as more people catch on, this trading opportunity should diminish. How long it lasts depends on the ability and determination of investors to review earnings estimates skeptically.

—By David Henry in New York

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Keeping Out the Wrong People

Tightened visa rules are slowing the vital flow of professionals into the U.S.

LIKE A FORLORN ESTRAGON from Samuel Beckett's *Waiting for Godot*, Zubair Malik has been waiting. And waiting. The 30-year-old Pakistani doctor applied for a U.S. visa in April after being accepted into the prestigious residency program at the Mount Sinai School of Medicine in New York. Five months later, he hasn't yet made it through the gantlet of security measures the U.S. set up for foreign visitors after September 11. Malik has missed training and orientation at Mount Sinai and fears he may never get to the Manhattan hospital. "I am still waiting for my security clearance," he says by phone from Pakistan. "My life is disturbed, and I am in severe depression."

Three years after the terrorist attacks in the U.S., tens of thousands of foreigners who are trying to get into the country to study and work have been caught in a thicket of new rules and restrictions. Students like Malik have been particularly hard hit. In 2003, the number of student visas issued by the U.S. dropped 8%, to 215,694, after falling 20% in 2002. Those are the two largest drops since the government began to track student statistics in 1952.

It's not just students who are affected either. The Homeland Security Dept.'s annual report on immigration, released on Sept. 13, shows declines across broad swaths of the populations trying legally to enter the U.S. The total number of immigrants—those granted the right to stay in the U.S. permanently—tumbled 34% in

2003, to 705,827, according to the report. Excluding a special amnesty program 15 years ago, that's the steepest decline since 1953, when Senator Joseph McCarthy stoked fears that communists were infiltrating the government.

While no one doubts the need for more rigorous border controls now, there are critics who say the federal government is doing a poor job of distinguishing between potential terrorists and legitimate travelers. Students, for instance, are seeing their visa applications

Last year the number of exceptionally skilled immigrants fell by 65%

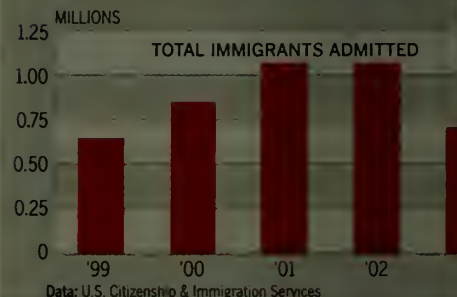
rejected in record numbers: The refusal rate hit 35% last year, up from the previous record of 34% in 2002 and the 20% rate in 1999. Plus, the immigrants with the most to offer the U.S. seem to be having the hardest time getting in: The number of workers with advanced degrees or exceptional skills who were admitted plummeted 65%

last year, to 15,459. "We're slapping these people in the face," says National Academy of Engineering President William A. Wulf. "The long-term costs in goodwill will be enormous."

The loss of raw smarts may come much more quickly. Booming economies across the world are serving as beacons of opportunity for the best and the brightest. China, India, and other nations are attracting the kind of people who once saw the U.S. as the No. 1 place to seek their fortunes. "I've lost recruits to other foreign companies," says Roger Coker, director of global staffing for Broadcom Corp., an Irvine (Calif.) chipmaker. "When we lose, it's because we can't give the candidate assur-

GIVE US YOUR TIRED, YOUR P

As the number of U.S. immigrants de



ance we can get him a visa. Today I can't hire the foreign-national engineers and scientists we need to run our business."

Of course, Corporate America can simply hire employees offshore, gaining the benefits of their labor without dealing with the hassles of bringing them to the States. But that's not a solution for all kinds of workers. Companies can't—or won't—send overseas their most critical jobs, whether it's top managers, product designers, or senior software developers.



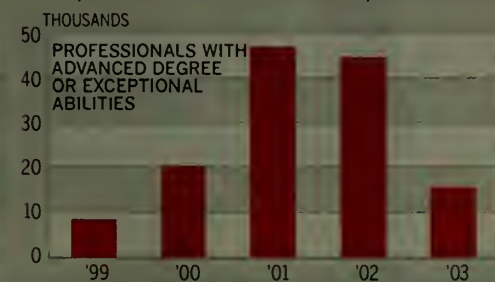
BEIJING Instead of queuing for U.S. visas, many skilled Chinese are seeking opportunity at home

YOUR SKILLED

...skilled workers are hit hard...



...and professionals see the sharpest declines



"The people that came here were not doing the outsourcing jobs. They were contributing at the highest levels and innovating," says Anna Lee Saxenian, dean of the University of California at Berkeley's School of Information Management & Systems. And the implication that outsourcing is a solution is worrisome to some: It means the U.S.'s inability to sort out trustworthy workers from security threats could accelerate the transfer of jobs overseas.

The situation in the U.S. is hardly a catastrophe now. Despite the recent declines, the number of skilled and professional immigrants in 2003 is more than the number in 1999. The number of student visas issued last year is about the same as 1994.

The fear is that the country, intentionally or not, will continue to discourage talented workers and students from trying to get into the U.S. If current trends continue, economists, academics, and

business leaders worry that the country could squander one of its greatest historical strengths: the talent and energy of skilled immigrants. From Albert Einstein to Intel Corp.'s Andrew S. Grove to Google Inc.'s Sergey Brin, high-skilled immigrants have helped establish U.S. leadership in many fields, creating new industries and pioneering areas of scientific endeavor. "We benefit enormously from high-skilled immigration," says Gary S. Becker, a Nobel Prize-winning economist at the University of Chicago. "We have to try to maintain that."

DAUNTING BACKLOG

HOW CAN THAT BE done? The U.S. government certainly faces a difficult balancing act. It instituted many necessary security measures in the wake of September 11—not only to keep out potential terrorists, but also to crack down on rampant fraud by foreigners using student visas to get into the country even though they had no plans to attend school. At the same time, the government has struggled to add the capabilities needed to meet those requirements, particularly in terms of people and technology. Visitors who work in technology fields, for example, must go through a series of new reviews, but few government staffers have the technical expertise needed to conduct the reviews. "We do not have enough consular officers and local employees who do the background checks," says Richard N. Holwill, a former ambassador to Ecuador and now vice-president of Amway parent Alticor Inc., which has been unable to hire several foreigners because of visa troubles. The result is that visa applications that used to take weeks now can take six months or longer. The backlog of applications hit an all-time high of 3.8 million in January.

The U.S. State Dept. and Homeland Security Dept. acknowledge the problems and are taking steps to speed the entry of legitimate travelers. The State Dept. is hiring more consular officers with technical backgrounds. Homeland Security's Citizenship & Immigration Services is using technology to accelerate its own reviews. Among other things, it's letting visa officers tap into a computer database to view an applicant's information, instead of having to retype data into local systems. On Sept. 23, Homeland Security Secretary Tom Ridge was scheduled to announce the backlog of visa applications had been sliced to 1.8 million during the first eight months of the year. Still, much work remains. Homeland Security says it needs additional funding to sufficiently

Information Technology Workforce



figure they have no chance of success

So what's the right mix? The University of Chicago's Becker argues the U.S. should "give the highest priority to people with high skills and allow large numbers to come in, maybe unlimited numbers." There's plenty of opposition to such a dramatic step. Politicians are reluctant to invite in foreign workers at a time when the U.S. job market is soft, particularly during an election year. And immigrant groups such as Hispanics would oppose any reduction in the absolute number of family-based visas. Experts believe that one feasible option would be to substantially increase the visas reserved for skilled people, while keeping family visas steady. That could lead to a ratio of 50%. "Our policy is too heavily tilted toward kinship," says Barry R. Chiswick, head of the economics department of the University of Illinois at Chicago. If the U.S. does not reform the immigration system, "we're going to become less competitive in the international market for high-tech manpower."

Since students are the farm team of the knowledge economy, educators say the reform program should feature a new strategy to attract the world's best prospects. For a generation after World War II, the U.S. used international student exchange as a strategic Cold War weapon. But after the Iron Curtain fell, the U.S. dropped the ball. The State Dept.'s Educational & Cultural Exchange budget has declined to \$245 million in 2003, from \$335 million in 1994, in constant dollars. That was boosted to \$317 million this year, but experts think that money should still be increased dramatically. "We could easily and productively spend double the amount [the State Dept. is spending]," says Michael McCarry, executive director of the Alliance for International Educational & Cultural Exchange, a Washington nonprofit organization. "We haven't been thoughtful about recruiting, and we certainly haven't put significant resources in it."

train its existing staff in languages, new technology, interview, and counterterrorism techniques. And government critics say both State and Homeland Security still need more staff and more streamlined policies, including long-term, multiple-entry visas for reputable scientists, engineers, and business travelers who need to visit the U.S. often.

Tweaking the existing system may be inadequate in this era of globalization, however. Many educators and economists say the country needs to modernize its immigration policy for the 21st century, remaking it to attract more skilled workers and students. The last overhaul

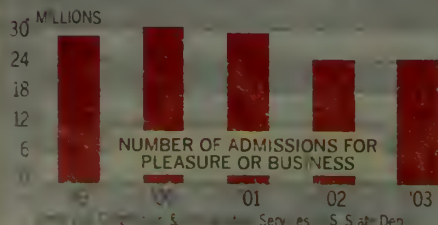
of the system came in 1965 under the Johnson Administration. At the time, 20% of the annual visas were set aside for professionals and other skilled workers, while 64% went toward family reunification. A carefully calibrated decision? Hardly. President Lyndon B. Johnson wanted 50% of the visas for skilled immigrants, but political horse trading resulted in the ratios that remain in effect today. The low cap means that many talented people from around the world may never even try to get into the U.S. because they

SHANGHAI DREAMS
Yang left the U.S. to become CEO of a Chinese startup

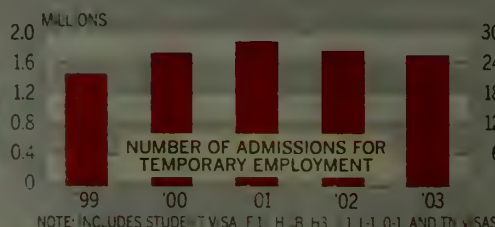
THE WELCOME MAT IS NOT AS WELCOMING

Because of a host of new terrorism-related security measures, fewer visitors, workers, and students are coming to the U.S.

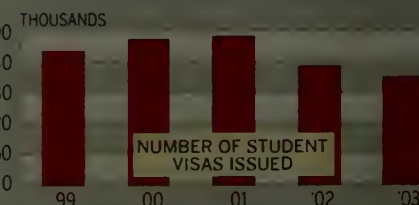
The number of tourists and business travelers has slipped...



...while admissions of temporary workers has fallen slightly...



...and the arrival of foreign students is off sharply



NOTE: INCLUDES STUDENT VISA F-1, H-3, J-1, L-1, O-1, AND TN VISAS

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Health
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Life

Make no mistake, there is fierce international competition for talented workers and students. Several developed countries have launched aggressive campaigns in recent years to attract foreigners. In May, the German government forged a deal to allow non-European workers to immigrate to Germany for the first time in decades. Australia has been adjusting its policies to attract students from other countries, sending its foreign-student enrollment up 53% since 2001. And Canada has instituted a federal innovation strategy, aimed at increasing its ranking in research and development to fifth in the world, from 14th. One law that went into effect in the summer of 2002 made it easier for skilled workers and students to stay in Canada. "These countries have been adjusting their systems to encourage and accommodate these people," says Demetrios G. Papademetriou, co-director of Washington-based Migration Policy Institute. "They have taken a ladle, not a spoon, and are helping themselves to this pool."

ENDLESS DELAYS

CHINA AND INDIA also are attracting talented workers like never before, even from the U.S. Consider Raymond Yang. For most of his 20-year career, the Chinese native worked in the U.S., in what he considered the big leagues of business. But last year, the 46-year-old agreed to become chief executive of Linktone Ltd., a

Shanghai-based startup that sells ring tones and other content for cell phones. "There are a lot of opportunities for people to fulfill their dreams here," says Yang. "China will get stronger and stronger."

American workplaces, universities, research labs, and other institutions are rife with stories of people who are being denied entry to the country. Alticor's Holwill says the company tried to get visas for several foreigners, but the delays dragged on for months. "A couple said 'screw this' and went to work for non-American companies," he says. Keith Nosbusch, chief executive of manufacturer Rockwell Automation Inc., said it had to delay its bid for a subway project in China for four months because a sales engineer from China couldn't get to the States for the training needed to finish the bid. And Elizabeth Dickson, head of immigration services for Ingersoll-Rand Co., says difficulties in getting visas have disrupted its training programs. "Rejections are very arbitrary," she says. "You can send someone with the exact same paperwork and get a different response from different consulates."

To get a sense of the disruptions on university campuses, consider Mississip-

pi State University. Its Electrical & Computer Engineering Dept. has been hard, like many other science and engineering programs, because of the government's shortage of visa reviewers with technical backgrounds. On the Starkville campus, enrollment of foreign undergraduate students fell 33% for the class of 2003, while graduate student enrollment declined 7%. What's more,

James C. Harden, the head of the Electrical & Computer Engineering Dept., says the problems have led to deterioration in the quality of students who specialize in digital computing. "Generally we would have more applicants in this area and they would be better," says Harden.

The problems at universities may get worse before they get better. On Sept. 8

the Council of Graduate Schools released a survey of 126 schools that showed an 18% drop in offers of admissions to international graduate students. Council President Debra W. Stewart says it would be "difficult to imagine that we will not experience at least an 18% decline in admissions" for the class of 2004.

Visa problems may be beginning to harm the quality and speed of research. Dr. Bing Su, an immunology professor who came to the U.S. from China in 1983 to get his PhD, says when he tried to come to the U.S. the Chinese government made it very difficult to leave. The irony, he says, is that "the screening is on this side now." What's more, he calls the screening "indiscriminate."

Indeed, one top Chinese PhD student he recruited last year enrolled in a university in Singapore because she could not obtain a visa after more than a year's effort. The cancer research of two other postdoctoral students was delayed more than three months due to visa problems. "In the short term it is hard to see a loss but ultimately there will be a very bad impact on research," says Su.

It's a sentiment that Zubair Malik can identify with. Back in Pakistan, he is growing impatient. He has requested an extension from Mount Sinai, but he is having second thoughts about living the American Dream. "I think again and again that my decision to pursue my career in the U.S. was wrong," he says. Without a new approach to U.S. immigration policy, there may be many more Maliks wondering the same thing. ■

—By Spencer E. Ante in New York

Canada and Australia are stepping up efforts to woo foreign students

How to Fix the Immigration Problem

Three years after September 11, tens of thousands of high-skilled foreigners trying to get into the U.S. to study and work have been entangled in new rules and restrictions. Here's how to make sure the country continues to attract the best and brightest:

IMPROVE THE VISA SYSTEM Visas that used to take weeks to get now take months. Rejected visas have hit a record 35% for students. To speed up and improve reviews, the government should hire more consular officers, particularly with technical and language skills, expand the duration of security clearances, and create a special visa allowing reputable workers to make multiple visits to the U.S.

REFORM IMMIGRATION POLICY Since 1965, immigration policy has been heavily tilted toward reuniting families. More than 70% of each year's immigrant visas go to family reunification, while only 20% are reserved for professionals and other skilled workers. In contrast, 54% of Canada's immigrants are skilled workers. It's time to increase the visas reserved for skilled immigrants to as much as 50%.

PROMOTE U.S. EDUCATION OVERSEAS The State Dept. used to market U.S. education to overseas students as part of Cold War foreign policy. But over the past decade, its Education & Cultural Exchange budget has declined 5%. Meantime, Canada, Australia, and other countries are courting foreign students more aggressively. The U.S. needs to devise and appropriately fund a new strategy for marketing higher education if it wants to continue attracting the brightest students from around the world.

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Can Cisco Shift Into Higher Gear?

Innovative rivals pose a rising threat in the company's biggest growth market

IN JUNE, 2003, CISCO SYSTEMS Inc. unveiled what seemed a landmark deal. Long known for making the gear used to move data around office networks and the Internet, the company trumpeted a major victory in telecom, saying it had persuaded BellSouth Corp. to install one of its products in the core of BellSouth's massive telephone system. For two years, Cisco engineers had whittled down a list of 158 improvements demanded by BellSouth technicians. With only a few to go, the companies went public with the deal. "We have made a tremendous amount of progress," said Cisco Senior Vice-President Jayshree Ullal at the time.

Not enough, evidently. *BusinessWeek* has learned that, 15 months later, BellSouth has not deployed a single piece of the Cisco gear. Because Cisco never finished the last of the requested improvements, so far the phone company has opted for products from rival Lucent Technologies Inc. "Cisco is still coming up the learning curve," explains BellSouth Vice-President Mark Kaish, who says his company may start installing the Cisco product by yearend.

Cisco needs to graduate fast to make the most of its single biggest growth opportunity. While the networking market it dominates settles into maturity, telecom and cable companies are beginning to

PRESSURE'S ON Chambers will have to hustle to satisfy the Street

make massive investments in new Internet gear. After decades of building separate networks to

deliver telephone service, cable TV, or Net access, giants from AT&T to Verizon Communications are building next-generation networks to deliver all that and more over one set of pipes that use Net technology. The market is expected to surge some 20% a year, roughly twice that of the corporate market.

But Cisco is struggling to fully cash in on the opportunity. A host of rivals, particularly Juniper Networks and China's Huawei Technologies, are gaining ground in selling Net gear to carriers. Juniper's share of the market has jumped from 4.5% in 2002 to 8.3%, while Huawei has gone from 3.8% to 8.2%, according to the market research firm Synovate Research Group Inc. Meantime, Cisco dropped from 45% in 2002 to 33% late last year, before recovering somewhat to 38% in the second quarter.

No doubt, Cisco will be a prime beneficiary of this Net migration to combo networks. At 38%, it's still the top player in selling Net-style equipment to phone and cable companies. And that position has helped boost Cisco's share of the overall market for communications gear to 6.1%, from 5.5% in 2002, because sales of older phone and cable gear have been declining in recent years. As Net equipment sales climb and Cisco markets new products, the company figures its share of total communications-gear sales is sure to rise. "The market is coming to us," says Carlos Dominguez, the Cisco senior vice-president leading its telecom push.

Cisco isn't waiting passively. On Sept. 23 it announced a \$32 million investment to create a Shanghai research and development lab to work with Asian communications companies. It also has been putting its \$19 billion in cash to work, buying promising startups.

Still, the company must confront a reliability gap. Cisco's gear is more than sufficient to keep office networks up and running most of the time. But for big telecom and cable outfits, a break of even 50 milliseconds can interrupt millions of phone calls or video transmissions. Customers say such disruptions would be too common with current Cisco equipment. "Today, you still have to hit the reset button on Cisco's routers [to add a new service]. That doesn't cut it," says David M. Fellows, chief technology officer for cable giant Comcast Corp., which buys Cisco equipment for Net traffic but wants im-

improvements before buying its gear for video and voice services.

Whether Cisco can rise to the challenge may well determine if Cisco Chief Executive John T. Chambers can meet Wall Street's expectations for brisk 15% annual growth over the next five years. It leads to some emerging markets, such as consumer wireless gear, but none is big enough to make much difference for the \$22-billion-a-year giant.

Unless it increases its 38% share of the Internet land grab with communications companies, it will fall short of that 15% mark, says JMP Securities LLC analyst Sam Wilson. "Cisco needs to get at least half of this market to meet Wall Street's growth expectations," says Wilson.

Gaining that much share seems unlikely anytime soon. Consider core routers, the refrigerator-size behemoths that hunt billions of bytes across countries and continents. Despite spending \$500 million in R&D, Cisco's new CRS-1 model is off to a slow start. By the time it was announced in May, some carriers already had chosen the routers they would consider for the next phase of their network overhauls. "I've seen it on paper, but not in the lab," says AT&T chief technology officer Hossein Eslambolchi, who just decided to extend by five years a contract to buy from Avici Systems Inc. rather than Cisco. Cisco router chief Mike Volpi

waves off criticism that the CRS-1 will be a disappointment. He says Cisco shipped one unit in August and that it is being evaluated by a dozen other customers.

Still, evaluations could take a year or more, and Cisco could lose important deals in the meantime. China Telecom Corp. is close to awarding a handful of contracts that could top \$500 million, say insiders. While it relied almost exclusively on Cisco for big routers in the past, the Chinese carrier is expected to give much of the business to two teams: one comprised of Huawei and Avici, the other Ericsson and Juniper. "Anything less than 100% [share of these contracts] would be an embarrassment for Cisco, and anything under 50% is a disaster. And I'm hearing numbers like 20%," says

Tom Nolle, founder of telecom consultant Cimi Corp. China Telecom declined to comment for this story. Cisco's Volpi says the company is "in decent shape with China Telecom," but he won't say how much of the contract Cisco is likely to get.

Even impatient customers, such as BellSouth, are giving Cisco the time it needs to meet their needs. "Cisco hasn't fallen out of the race," says Kaish. Still, if it doesn't pick up the pace, its best chance to regain hot-growth status may slip away for good. ■

—By Peter Burrows in San Jose, Calif.

As it stands, many Cisco products aren't up to telecom standards

Cisco's Telecom Challenge

CEO John Chambers has long said that the networking giant's biggest opportunity is to sell Net-style gear to large phone and cable companies as they build next-generation networks. That may be easier said than done.

BAD TIMING Over the past year, as many phone companies chose gear for new networks that use Internet technology, Cisco struggled to get its CRS-1 high-end router to market. While available now, the product has new, untested software that could delay mass deployment for years.

IFFY RELIABILITY Cisco built its success on selling networking gear to corporations, which gladly accept a few hours of downtime in exchange for good support and pricing. But phone companies can't afford even seconds of having no dial tone or shut-down Web access. Cisco's questionable reliability has given rivals Juniper and Avici an edge.

MEDIOCRE INNOVATION Cisco hasn't led the way in offering phone companies innovative products. Years ago, Juniper and Avici introduced bullet-proof software that lets telecom companies add or update new features on the fly. Cisco doesn't yet have a comparable product.

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BIG,
BUT DO THEY
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A Breakthrough for MIT—and Science

Five years after conceding rampant sexism, MIT has a new president, Susan Hockfield



MASSACHUSETTS INSTITUTE OF TECHNOLOGY shocked academia five years ago with a scathing report about how it had discriminated against female scientists. Although many were world-class, the country's most prestigious science university publicly confessed that its male-dominated culture had marginalized them. Women were paid less, received fewer resources, and were often treated as if they were "invisible," the report concluded. Moreover, despite a flood of women earning PhDs, their share of MIT's science faculty hadn't risen in more than a decade. In MIT's entire history, no woman had ever headed a science department.

Fast-forward five years: In early December, Yale University provost Susan Hockfield will take over as MIT's new president. In a country where female scientists remain constrained by a forbidding glass ceiling, the appointment of the neuroscientist is being hailed as a major breakthrough. "This will have a tremendously important impact on American science," predicts Yale University President Richard C. Levin.

Hockfield, 53, hardly wants to be confined to women's issues and is developing a sweeping agenda for MIT. In six years as a top Yale official, she accelerated a \$1-billion program to modernize the university's science facilities while boosting graduate students' pay and launching new programs to give them more support. While Hockfield hasn't yet developed a detailed plan for MIT, she must grapple with a growing list of challenges including shrinking government funding for research, a sharp drop in applications from foreign students, and the growing importance of biotech at a university renowned for engineering and the physical sciences. She also hopes to use her post as a bully pulpit to reverse what she considers an alarming slide in U.S. science overall. "In the second half of the 20th century we led the world in innovation, but now we're not keeping up with other countries in our investments in science and engineering," she says.

At the same time, Hockfield, who was a renowned neuroscience researcher before moving into administration, will likely be a role model in efforts to promote women scientists. While there has been a huge jump in the number of young women

LAB RAT Hockfield made her name as a neuroscience researcher

tudying math and science since the early '70s, few are rising to the top in either academia or industry. In effect, "we are throwing away the potential of half of our nation," argues Hockfield.

The problem isn't a lack of interest on the part of female students. Since 1972, the number of women earning degrees in science and engineering has grown dramatically (charts). Today, women earn more than half the nation's bachelor's degrees in biology, nearly half of those in chemistry, and some 21% in engineering, up from just 1% in 1972. Similarly, in 1972, few women earned PhDs in science. Today they account for over 40% of PhDs awarded in the life sciences, over 25% in the physical sciences, and some 16% in

hold just 15% of full professorships in biology and under 10% in other science and engineering fields. "We are not near getting to a critical mass of women," concludes Jong-on Hahm, head of the committee on women in science and engineering at the National Research Council. At the rate women are being added to faculty ranks, she says, they won't be representative for decades.

One major barrier: the long hours typically required to advance in many hard-science jobs. After finishing a PhD and post doc, putting in 6 to 10 more years on a science tenure-track position makes it tougher to start a family. And a recent study by the General Accounting Office found that few newly minted female

and children. Her first break came a year after earning her doctorate in anatomy and neuroscience at Georgetown University, when she landed a research job at Cold Spring Harbor Laboratory on Long Island under James D. Watson, the Nobel laureate for his contributions to the discovery of the double helix of DNA. "I was analyzing data late into the night and never went home before midnight," she recalls.

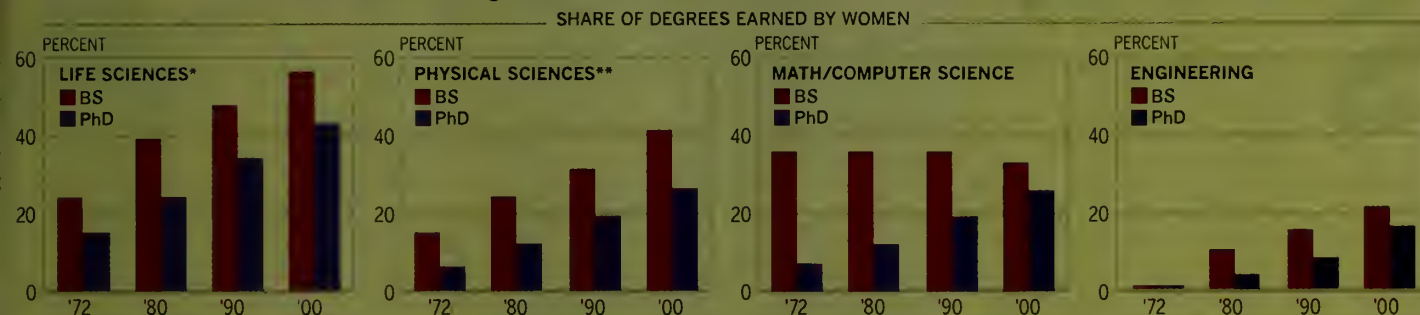
NEW HAVEN INCUBATOR

WATSON SOON ASKED Hockfield to take over Cold Spring's prestigious summer courses in neurobiology. After five years, she jumped to the Yale University School of Medicine, where she conducted research on the brain, including how the vi-

THE LAST BASTION

Women have made gains in some academic fields...

...but still lag in engineering



*LIFE SCIENCES INCLUDE SUBJECTS SUCH AS BIOLOGY AND PSYCHOLOGY

**PHYSICAL SCIENCES INCLUDE SUBJECTS SUCH AS CHEMISTRY AND PHYSICS

Data: Government Accountability Office; Donna J. Nelson, University of Oklahoma; National Science Foundation

engineering. This stands in sharp contrast to declining male interest. In 1973 men earned a record 225,000 bachelor's degrees in science. By 2001 that had fallen to 198,000, even as the number of women earning science bachelor's degrees more than doubled, to 203,000.

STILL A NEAR SHUT-OUT

YET WOMEN STILL FACE enormous obstacles in academia and the workplace. Despite all those PhDs in math and science, female presence drops off sharply among assistant professors in these subjects, according to a Ford Foundation study of hiring at the nation's top 50 research universities conducted by Donna J. Nelson, associate chemistry professor at the University of Oklahoma. In biology, Nelson found that while women won 45% of PhDs from 1993 to 2002, they held just 30% of assistant professor jobs in 2002. Similarly, they earned 21% of computer science degrees but had only about half that share of assistant professor slots in the field.

The problem gets worse at higher levels. At top research universities women

PhDs seek tenure-track positions at research institutions. "If a woman decides she is going to have a family, [university science departments] equate that with not being serious," says Nelson.

Women haven't fared much better in the workplace. They accounted for 25% of information-technology workers in 2002, the same level as in 1996, according to a study last year by the Information Technology Association of America, an Arlington (Va.) lobbying group. The barriers are largely the same as in academia, the report found: long hours that conflict with family responsibilities, few female role models, and old-boy networks that are difficult to crack. "We know we have fundamental problems with women in high tech, but dealing with them involves changing a lot of social and cultural factors, which isn't easy," says ITAA President Harris Miller.

Hockfield managed to break through these barriers at every stage—putting in long hours and delaying marriage

and children. In 1991 she won tenure—a year ahead of schedule—as Yale moved to hang on to its rising star.

To be sure, Hockfield, who didn't marry until the year she got tenure, wasn't distracted by a family. She was also lucky to land at Yale, a clear leader in grooming women for academic leadership. Three of Hockfield's predecessors there went on to head major universities: Alison Richard, now vice-chancellor of Britain's Cambridge University; Judith Rodin, ex-president of University of Pennsylvania; and Hannah Gray, former president of the University of Chicago.

It was at Yale that Hockfield proved her talent for administration. When she became dean of the graduate school of arts and sciences in 1998, Yale was lagging in the competition for grad students, and teaching assistants were demanding a union. Hockfield boosted grad students' base stipend by 50%, to \$15,000, by 2002, and gave them free health care. She also

**In science,
just 10%
to 15%
of full
professors
are
women**

beefed up career advice and minority outreach. The payoff? Grad program applications doubled, as did minority enrollment, and the union was voted down. "She had a transformational impact," says former Procter & Gamble Co. Chairman John E. Pepper Jr., now Yale's vice-president for finance and administration.

Hockfield also pressed to hire more women. When she took over, the comput-

er science department had no women. Today there are four female faculty, plus three in physics, up from zero when Hockfield arrived. "It's amazing how fast these things can happen" when attitudes change, she says.

She faces a similar challenge at MIT. The 1999 report prompted it to stop the seven-year tenure clock for a woman who has a child, in effect giving her an extra

year. And search committees look at more diverse applicants. Today there are 51 female engineering faculty, up from 31 in 1999. University-wide, women make up 17% of the faculty, vs. 11% in 1993. "There is wonderful momentum, and I will work to continue it," says Hockfield. If she succeeds, the impact will be felt far beyond the labs and classrooms of MIT. ■

—By William C. Symonds in New Haven

ON THE RECORD

MIT's Chief on America's Slide and How to Fix It

Susan Hockfield will become the first female president of Massachusetts Institute of Technology in early December, taking on huge challenges at the premier U.S. science school. She spoke with *BusinessWeek's* Boston bureau chief, William C. Symonds, in her office at Yale University, where she has spent nearly 20 years, the last two as provost. Now she's getting ready to move to Cambridge with her husband, Thomas N. Byrne, a neurology professor, and their 12-year-old daughter.

Why are you so concerned about the future of U.S. science?

Because we're falling behind. We're not keeping up with other countries in our investment in science and engineering. The science and math scores for our high school graduates are disastrous. We're underfunding research in the physical sciences, and we're lagging seriously on publications in these sciences. This is a problem for our economy, and we have to think about where we want to be 20 to 40 years from now.

What should we be doing at the K-12 level?

After Sputnik we turned our focus to math and science and were inspired about this. My sense is that we have lost this. We need to raise expectations. [Only] a small group of U.S. kids can compete with the best in the world. But golly—there are children in the next group who could be world leaders but who don't have the opportunity because their education is not sufficient. We need to reinspire the nation to value the people who work in science and technology.

Why is the number of students majoring in engineering and the physical sciences at the undergraduate level declining?

The life sciences and biotechnology are fabulous right now. But in the physical sciences, the future is bleak. So when a student talks to a guidance counselor and learns that funding is not good and that it will be hard to go to graduate school, [he or she loses interest]. At the same time, when many students arrive at college, their

“There are children... who could be world leaders but who don't have the opportunity because their education is not sufficient”

intellectual equipment is insufficient for them to take on the rigors of a bachelor's degree in engineering or the physical sciences. It is hard work.

What does that mean for our economy?

We see the consequences. If you look at any industry with a big demand for people in the physical sciences and engineering, an increasing number of the people working in those industries are non-Americans.

Yet now the number of foreign students coming to the U.S. is falling, right?

Nationally we've seen a 30% falloff in applications for graduate school from international students. A lot of things feed into this. It is very hard to get into the U.S. now. Yet Canada, Australia, and Britain are making it easier for people to go there for graduate education.

Why is that a problem?

People have come from around the world to be educated in the U.S., and they have stayed. They have become part of America's economic engine. And it's not the case that we have plenty of native-born Americans to fill these roles. So if we cut off these opportunities, these people will go somewhere else. And ultimately, we could lose our position as a world leader in science and technology.

Why is it so important that women move up in the academic world?

Universities play an absolutely critical role. They are training the next generation of leaders. And while I was not daunted by not having women faculty, it is hard for [many women] to imagine a career [in a university] without seeing someone to set the path. And second, the U.S. is falling behind in our

production of scientists and engineers. We need every person in the nation who has a love of science and technology.

What do you think your appointment as president of MIT will mean to young women?

I'm hoping it will give confidence to girls and young women that there are opportunities that will be open to them that they can't imagine right now.



The Muddle In the BCS Huddle

Will a deal to expand the Bowl Championship Series get sacked by TV?

AFTER YEARS OF SQUAB-
bling, including con-
tentious hearings on
Capitol Hill, the leaders
of big-time college foot-
ball sealed a tentative
peace agreement last
spring. It guarantees the marginal con-
ferences greater access to the lucrative
Bowl Championship Series—but it was
written in pencil. Now, TV negotiations
that began in September will test
whether the deal risks destroying the
games that lay the golden eggs.

The BCS is a four-bowl partnership cre-
ated by the Atlantic Coast, Big East, Big
Ten, Big 12, Pac-10, and Southeastern
conferences, plus Notre Dame. It rotates
the national championship game among
the FedEx Orange, Nokia Sugar, Tostitos
 Fiesta, and Rose Bowls. Still, the BCS has
failed to quell controversy over which
team deserves to be No. 1. Last year critics
howled when the BCS rankings put Okla-
homa in the title game instead of unde-
feated University of Southern California.
But the money keeps flowing. The series
will ring up \$93.1 million this year to
fund the college sports monster.

So with ABC Sports' eight-year, \$550
million BCS contract
scheduled to expire in
2006, the renewal negotia-
tions could have a far-
reaching impact on the
future of the series and the
provisional cease-fire be-
tween the haves and have-
nots. "This whole thing is
about creating access to
something that has proven
successful," says Big East
Commissioner Michael A.
Tranghese. But he ques-
tions whether the market-



WRONG TEAM?
Oklahoma
played for the
championship

place will support access for the upstarts.

The problem is that the deal ham-
mered out at the college-president level
to create a fifth bowl game and provide
an easier route for the
lesser teams to qualify
may weaken the BCS as a
TV property. Fearing that
more games featuring
teams from lower-level
leagues could drive down
ratings and advertising
rates, ABC Sports execu-
tives—who say they're al-
ready losing money on the
series—caution against di-
luting the powerful BCS
brand. "We do write a
pretty big check, and we'd

like to think they're listening," said
Loren Matthews, senior vice-president
for programming and production at ABC
Sports, before the talks. "But ultimately
it's [the conferences'] ball game, and they
set the rules."

In a high-stakes contest that had less to
do with first downs and passing yardage
than with political leverage and media
savvy, Tulane University President Scott
S. Cowen, leader of the outsider forces,
railed last October against the consortium
as an "unjust and unjustifiable" system,
denying five Division 1-A conferences en-
try to the national championship process.
Cowen and his allies took their fight all
the way to Congress and raised the pos-
sibility of an antitrust lawsuit. "The
threats were particularly galling,"
says University of Oregon Presi-
dent Dave Frohnmyer, who led
the effort among the BCS confer-
ences to reach a compromise.

MIXING BOWLS

PAINTED INTO a corner by their
presidents, a scandal-weary lot
who wanted to avoid a long pub-
lic fight, the BCS commissioners
agreed in May to add a fifth game,
to be rotated among the current
four sites, so that one of the four
would host two bowls each year,
perhaps two weeks apart. But TV
will determine whether the new
structure works financially. "We've
always said this was a solution
that needed to be tested in the
marketplace," says Big 12 Com-
missioner Kevin L. Weiberg, coor-
dinator of the BCS. "What consti-
tutes a failed test, we aren't
prepared to say."

ABC committed \$300 million
over eight years to renew its Rose
Bowl contract in August, and the net-
work's exclusive window with the other
three games, which negotiate as a unit,
extends until early November.

With college officials suggesting that
the overall system must generate at least
20% more revenue per year to justify in-
clusion of the new game, college football
faces a potentially defining moment this
fall. If ABC doesn't offer enough money,
and if another network isn't prepared to
meet the bowls' asking price (or make a
bid to share the series with ABC), the big
six leagues could be forced to choose be-
tween keeping peace in the family and
protecting their own rich revenue stream.
That could prove to be one of the trickiest
fourth-and-inches calls in history. ■

—By Keith Dunnivant

THE STAT

20%

more revenue:
The amount the
new BCS deal must
generate in order
to work financially

Sir Martin's Shopping Spree

WPP Group is adding Grey Global. Can he keep growing by conquest?

SIR MARTIN S. SORRELL, CEO of British communications giant WPP Group PLC, is characteristically understated about the latest \$1.5 billion goody he has tossed into his shopping basket. "I wouldn't describe it as a must-have," says Sorrell of acquiring Grey Global Group Inc. on Sept. 12. "I would describe it as a very-nice-to-have." After all, there was hardly heated competition for the New York advertising company, which has been struggling to boost margins in a fast-consolidating industry. WPP's top three rivals didn't even make a bid, and smaller competitor Havas offered substantially less. But with Grey, WPP would have a combined revenue of about \$8.6 billion last year—essentially matching Omnicom Group Inc. as the industry's largest player. More important, it gives him a chance to quickly ratchet up profits by merging the back office and cutting the workforce.

GONE FISHING

FEW KNOW MORE about the forces squeezing advertisers right now than the man who 19 years ago bought a shell company called Wire & Plastic Products and, with nonstop acquisitions, turned it into a global communications force with two of the most storied ad agency names in the world: J. Walter Thompson and Ogilvy & Mather. Sorrell has built healthy 14% margins through reducing his reliance on traditional advertising—where the cost of network television has outstripped inflation even as audience numbers have fallen—and by cementing his leading position in the higher-growth Asia-Pacific markets. He has also been aggressive in snapping up the few big fish that are still swimming solo—not to

mention their marquee clients such as Grey mainstay Procter & Gamble Co. This allows Sorrell to shrink fixed costs and provide a full array of services to clients.

The CEO, who calls himself the "poor man's Warren Buffett" because he writes essays in his annual reports, has plenty of challenges as he digests his latest acquisition. One is simply integrating Grey, a company of 10,500 employees, into a family that already includes Ogilvy, Thompson, Young & Rubicam, Cordiant, and numerous other players.

There have been hiccups in WPP's past. After buying Y&R four years ago for \$4.7 billion, WPP saw a management and client exodus after. That integration is now going "quite" well, says Sorrell, though he stresses that he means "quite" in the more modest English sense of the word. Now there are industry rumors of more client defections after the latest deal. While Sorrell brushes those aside, getting archrivals such as P&G and Unilever, and Mattel and Hasbro, to co-exist under one roof might not be easy. And if they do stay, such clients will undoubtedly hammer hard to lower the fees they pay.

Certainly, Grey CEO Edward H. Meyer was feeling the pressure. After 34 years in the top job, Meyer felt the advantages of joining a bigger outfit were too strong to resist. He'll continue to run Grey



Martin's World

How Sorrell wants to shape WPP

MARKETING WHIZ Expand public relations and other marketing services, so that traditional ad and media buying shrink from almost half to a third of sales.

FOREIGN SERVICE Boost Asian operations as the share of business from Europe shrinks.

CREATIVE JUICES Rev up the creative talent and reputation of WPP's agencies.

HAPPY FAMILY Integrate new acquisitions to boost margins and keep those volatile egos from bolting for the door.

through the end of 2006. Although the 77-year-old Meyer jokes that he had to convince Sorrell, 59, that he wasn't after his job, he is eager to join WPP's board. Says Meyer: "I want to see how he did it and how he does it."

He's not alone. Sorrell has hardly any big acquisition targets left to pluck for his portfolio, and a lot of people are wondering about his next act. Analyst Michael B. Nathanson of Sanford C. Bernstein & Co. points out that holding companies have already snapped up more than half of the big 15 independent agencies of the early 1990s. He argues that WPP should chan-

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nel more of its abundant cash—it generated \$800 million last year, despite the ad recession—into investors' pockets. "A lot of people wish they would buy back shares or increase dividends," he notes. Sorrell recently boosted dividends by 20%, but splitting the pot hardly seems to be his top priority at the moment.

Sorrell has other things on his mind. He wants to expand in Asia-Pacific, arguing that "the West underestimates the potential power of the East and the shift of wealth that is taking place already." He'll need his war chest to acquire agencies in developing markets. And he is

Sorrell is gearing up for the coming ad boom in Asia

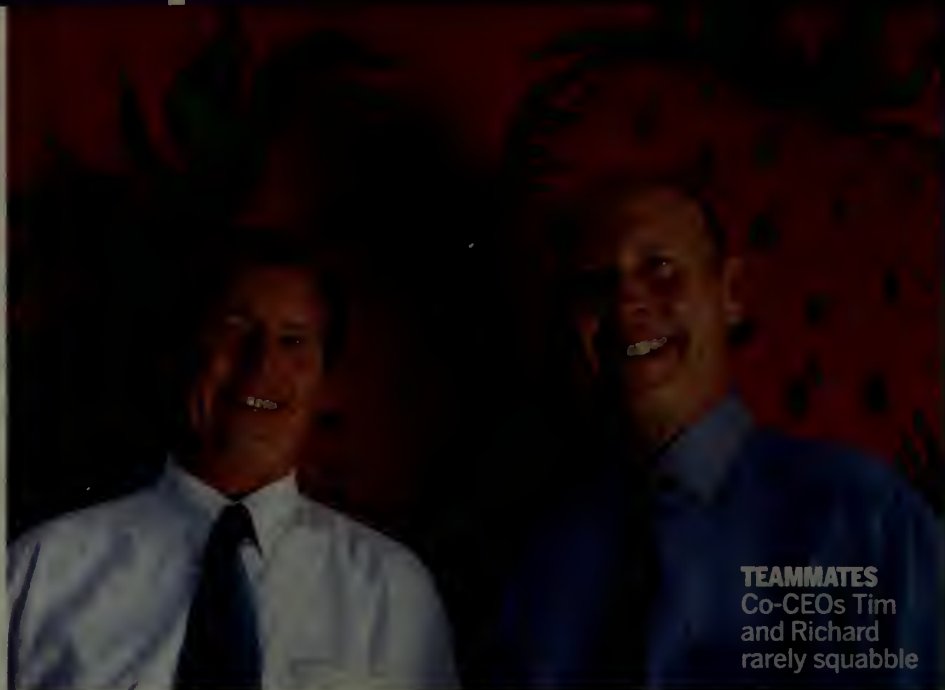
nervous about the ad business in the the all-important U.S. market, where, Sorrell says, the heavy government outlays and the mounting federal budget deficit mean that "whoever is elected will probably have to deal with a weak

dollar and growing inflation." Meanwhile, he compares Western Europe—a shrinking part of his pie—to a mature company saddled with hefty health-care and pension costs, while resisting the immigration that could actually spark growth.

Traditional advertising, with its reliance on 30-second television spots, is also fading on Sorrell's radar screen. The rising cost of network TV, as well as the fragmentation of mass media, has clients eager for alternatives. Among the hot areas: cable, satellite, outdoor ads, guerrilla marketing, online advertising, and radio. Sorrell continues to beef up those parts of the business, so as not to lose clients to smaller, nimbler rivals.

Grey brings a similar mix of businesses. It also brings another chance for Martin Sorrell to strut his stuff. Look for the master of cost-cutting to bring new technology to Grey, gaining efficiencies in everything from telephone contracts to employee benefits. He even welcomes the chance to work with the "equally obsessive" Meyer. "I call him Mr. Meyer, and he calls me Sir Martin," he laughs. It's a title that Sorrell no doubt feels he has earned. As he puts it: "We haven't done badly for a little wire basket manufacturer." Another understatement, perhaps, but Sorrell knows the value of a subtle pitch. ■

—By Diane Brady in New York



TEAMMATES
Co-CEOs Tim
and Richard
rarely squabble

Keeping Out Of a Jam

The Smucker brothers are doing some shopping to maintain their independence

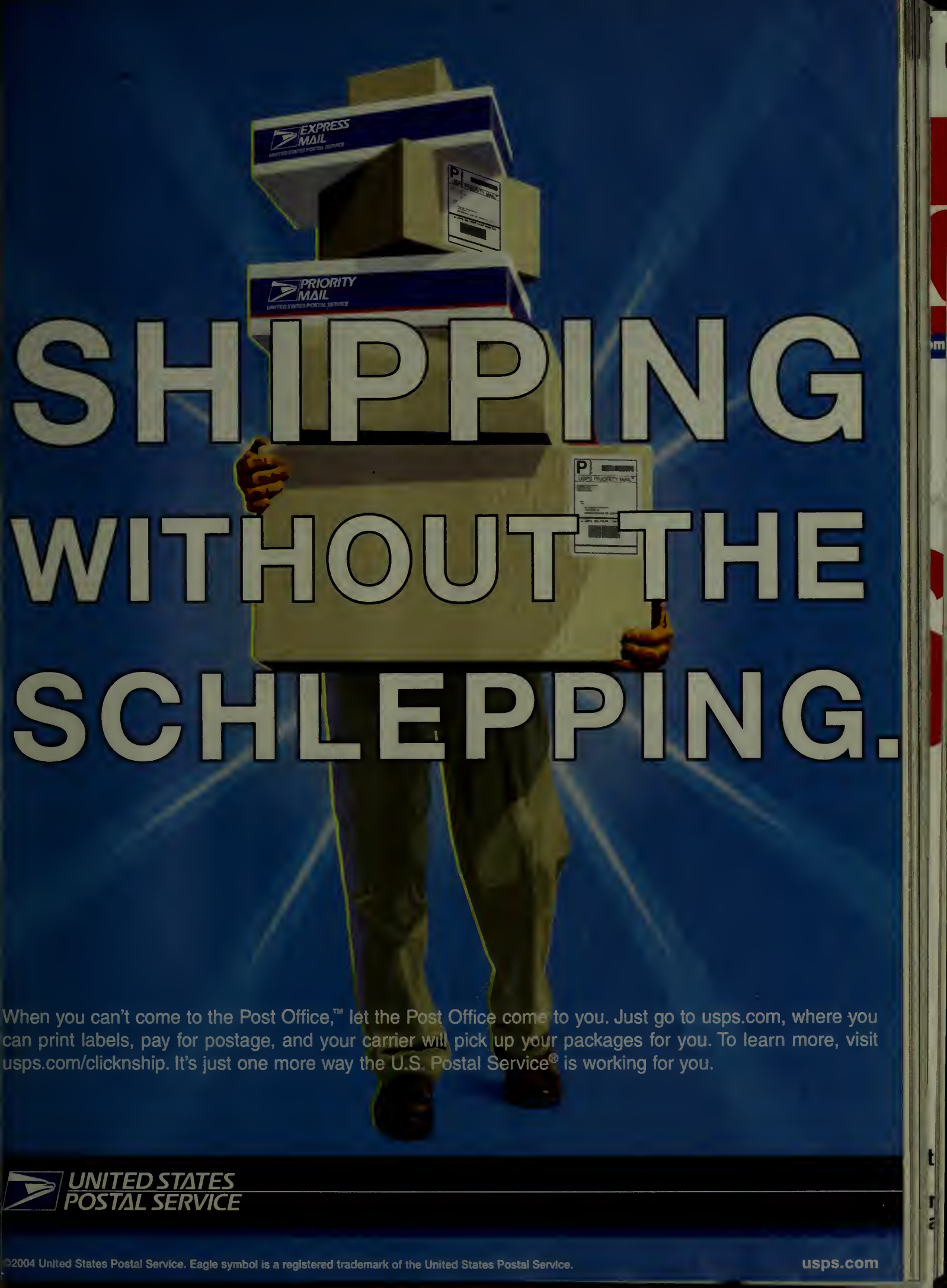
TIMOTHY P. AND RICHARD K. Smucker, the brothers who serve as co-chief executives of J.M. Smucker Co., are unabashedly old-fashioned. The deeply religious pair refuses to advertise their jams, jellies, peanut butter, and cooking oil on some of television's biggest hits because they deem the content offensive. Even as they build their once-sleepy foodmaker into a global powerhouse, they keep it based in tiny Orrville, Ohio, a town where tractors may only slightly outnumber churches. And as consolidation sweeps the food industry, the brothers are determined to keep their 107-year-old company independent—a stance backed by five younger Smuckers in management and other family shareholders.

To gain the heft necessary to fend off potential acquirers, the Smucker brothers have been doing some shopping. In

June they bought International Multi-foods Corp. (IMC), famous for its Pillsbury and Hungry Jack brands, for \$840 million in cash and stock. Smucker's growing portfolio also includes Jif peanut butter and Crisco oil, acquired from Procter & Gamble in 2002. The company now boasts No.1 market-share positions in fruit spreads, peanut butter, and cooking oil. "They've hit their stride," says Christina McGlone, an analyst for Deutsche Bank Securities Inc. For the fiscal year ending in April 2005, McGlone expects Smucker's earnings to grow 35%, to \$150 million, on \$2.1 billion in sales, up 48% from the previous year.

SIMMERING ISSUES

BUT THE EXPANSION brings some challenges. The brothers will have to come up with a plan to goose sales of Crisco, which stalled recently when rival Wesson cut prices. And they need to fig-



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People Brand Builders

ure out how to make money on Uncrustables, a line of frozen sandwiches that hauls in \$50 million a year in sales but has been unprofitable since the company bought it from a pair of inventors in 1998. Part of the problem is Smucker's fat cost structure. Its operating margin, minus restructuring costs, is expected to dip almost a full percentage point this year, to about 12.9%—two to three points below the industry norm. Investors are clearly questioning Smucker's propensity to buy slow-growing, low-margin brands that may drag down the company's profit-growth potential: The company's stock has fallen from a high of \$53 in May to a recent \$44.

The Smucker brothers aren't fretting about Wall Street just yet. The two, along with a sister and an aunt, control about 12% of the company's shares, the single-largest stake. That gives them some freedom to prove out their strategy for boosting the bottom line.

The brothers detailed that plan recently after a



lunch in the modest former home of their great-grandfather, company founder Jerome M. Smucker, which is now on the grounds of the company's headquarters. As they enjoyed a dessert of ice cream topped with Smucker's chocolate sauce, they laid out their goal of 8% sales growth a year, half from buying complementary brands that will fit easily into Smucker's distribution system. They'll cut jobs as needed, but value their long-standing reputation for providing a good workplace too much to be cutthroat about it. So long as their stock rises over time—even with its recent slide, it trades at double the price it was in late 2000—they're satisfied. "We take a much longer-term perspective," says Richard, 56. "You can do that in a family business."

Family has always been at the heart of the brothers' approach. Richard and Tim, who have been close ever since they were boys growing up in Orrville, began working at the company as teens. After both graduated from the University of Pennsylvania's Wharton School of Business, they started working closely with their father, Paul, who had been Smucker's longtime CEO. Paul died in 1998 and the brothers formally as-

to purchase Mrs. Smith's frozen-pie business in 1994, he was cool on the idea, having failed in a similar venture previously. But Paul let the pair go ahead. Smucker wound up selling the unit for a slight loss two years later. Still, the Smuckers praise their father for allowing them to try.



BIOS

Timothy P. Smucker Richard K. Smucker

Working to preserve a 107-year-old family business tradition:

BORN Tim on June 29, 1944, in Wooster, Ohio; Richard on May 16, 1948, in Salem, Ohio.

EDUCATION Tim: B.A., Economics, The College of Wooster, 1967; MBA, The Wharton School at the University of Pennsylvania, 1969. Richard: B.S. finance, Miami University of Ohio, 1970; MBA, Wharton, 1972.

CURRENT POSITIONS Tim is chairman and co-CEO of J.M. Smucker Co.; Richard is president, co-CEO, and CFO.

CAREER PATHS Both have worked at the company since their teens. Tim held marketing and operational posts before being named chairman in 1986. Richard held financial

and operating posts before being named president in 1986. They became co-CEOs in 2001.

PROFESSIONAL COUP After their father tried for 25 years to buy Jif from Procter & Gamble, the brothers finally closed the deal in 2002.

FAMILY Both are married. Tim has three children and three grandchildren. Richard has one daughter.

HOBBIES Tim skis, boats, and serves as chairman of the board at his Christian Science church and superintendent of its school; Richard, a golfer, has also been a lay leader at the Christian Science church he attends.

IN TRAINING Tim (left) and Richard started to work for dad in their teens

The straight-talking co-CEOs say Smucker's culture springs from a deeply felt religious tradition handed down from great-granddad J.M. The farmer and committed Mennonite, who churned out apple butter for his Orrville neighbors, had his well-thumbed Bible in mind when he founded the company, especially the passage promising that you will reap as you sow. The brothers say that means treating one another, along with customers, suppliers, and

staffers, with respect. The co-CEOs, who were raised as Christian Scientists, are both lay leaders in their churches, and they say religion is a big influence on how they manage. They view advertising to kids as manipulative, for example, so they pitch their famous line, "With a name like Smuckers, it has to be good," directly to Mom instead.

FATHER KNEW BEST

THE SMUCKERS SAY the secret to their harmonious relationship is a consensus-oriented, willing-to-compromise style learned from their father. As the brothers began making key decisions, their father cut them a lot of slack. When they wanted

staffers, with respect. The co-CEOs, who were raised as Christian Scientists, are both lay leaders in their churches, and they say religion is a big influence on how they manage. They view advertising to kids as manipulative, for example, so they pitch their famous line, "With a name like Smuckers, it has to be good," directly to Mom instead.

The Smuckers have set up employee groups to brainstorm ways of keeping Smucker's growth on track. "It sets the tone that we're all in this together," Tim says. Together and fighting hard to hold onto the Smucker family's legacy—a company that somehow manages to remain independent in an industry hungry for consolidation. ■

—By Joseph Weber in Orrville, Ohio

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What's Lurking In Your PC?

How to keep spyware from tracking your habits—or hijacking your computer. **BY TODDI GUTNER**



AT FIRST I WAS JUST mildly irritated when my Internet browser opened up to a strange Web site rather than to my regular home page. I figured I must have inadvertently hit a wrong key. When I tried to reset it, nothing happened. Again, I thought I must be doing something wrong. But since the problem didn't prevent me from using my computer, I decided to deal with it later. 🐞 Big mistake. Just weeks after my home page was hijacked, I got hit with an onslaught of pop-up ads. Then I was unable to complete a Web search. Despite typing an address dozens of times, I always ended up somewhere else. 🐞 Time to call a computer expert. His diagnosis? Spyware. As it turns out, one-third of Internet users have been similarly afflicted, according to a recent survey by *Consumer Reports*. "Spyware, without question, is on an exponential rise over the last six months," says Alfred Huger, senior director of engineering with Symantec Security Response, the maker of Norton secu-

rity software. Microsoft reports that spyware was the cause of one-third of all computer crashes in the past year.

Because it's so new and still evolving, many computer users don't understand spyware. Here's a quick tutorial to bring you up to date on this insidious problem.

What is spyware?

It's a broad term for deceptive software that surreptitiously installs itself on a computer via the Web. Once it lurks on your PC or laptop, it allows an outsider to harvest your personal information, which can be used for many purposes. In its most benign form, a kind of spyware known as adware tracks Web surfing or online buying so marketers can send you targeted—and unsolicited—ads. Other spyware may have a more malicious intent, such as stealing passwords or credit-card information. Having a number of unauthorized programs running on your

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120 | Barker: Dresser for success?



PC at once makes it sluggish, unstable, and, ultimately, more likely to crash.

How do you know if your computer has been infiltrated with spyware?

Unlike viruses, which are often invisible, spyware exhibits a host of signs that "take away a user's ability to control the computer," says Michael Steffen, a policy analyst at Center for Democracy & Technol-

ogy in Washington. Hijacked home pages, redirected Web searches, and a flood of pop-up ads are common complaints.

How does spyware sneak on board?

Simply clicking on a banner ad can install spyware, says Dave Methvin, chief technology officer at PC Pitstop, a system diagnostic and tune-up site. Worms, which are self-propagating viruses, can also carry spyware. They search for machines that don't have up-to-date security patches and install the nasty software, says Firas Raouf, chief operating officer for eEye Digital Security, a network-security software developer. Spyware is also spread by e-mail.

Sometimes spyware is secretly bundled with free software you download from the Internet. Sites that offer music-sharing, videos, weather data, games, and screen savers often are paid to distribute adware. When you install the software, you might see a pop-up window that asks you to agree to certain conditions. Most users just click "I agree" without reading the fine print. Often they are authorizing the installation of additional data-collection and ad-serving software that can muck up their PCs.

Another deployment method is to "trick users into consenting to a software download they think they absolutely need," says Paul Bryan, a director in the security-and-technology unit at Microsoft. You might also encounter what experts call "unsolicited downloads" while you surf the Net. In such cases, your browser will warn you that a file is being downloaded. You can choose to accept the download or not, but it will keep nagging you to say yes. Keep clicking no and the messages will eventually stop.

Is spyware legal?

With adware, which collects data on your buying habits, there's a fine line between what's legal and what's not. Marketers that use adware claim to get the consumer's consent to download the tracking software. But some experts say their tactics are deceptive. Those interested in identity theft—or geeks who simply want to wreak havoc on people's computers—are clearly engaged in illegal activities.

How do you get rid of spyware?

To eliminate it, you must track down every file and completely erase it. That can be tough since spyware hides inside your computer's operating system, making it difficult to find.

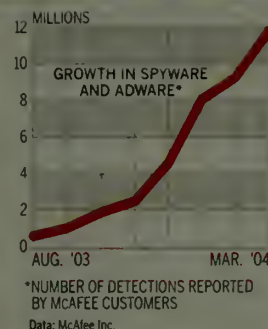
Internet service providers, such as EarthLink and AOL, offer scan-and-removal tools. For extra protection, you should also employ specialty anti-spyware software. Be careful about the programs you choose—they

may be spyware disguised as spyware cleaners. Use a well-known program that scans for a regularly updated list of privacy threats. McAfee Anti-Spyware, Sypwep, Lavasoft's Ad-aware, and Spybot Search & Destroy are all good choices. You can download the last two for free from download.com. Scan your hard drive at least once a week with two or more anti-spyware programs because each is likely to find files the other overlooks. For files that can't be deleted, contact a computer consultant.

How do you protect your computer in the future?

Protection is an ongoing process since spyware makers are constantly creating new threats. First, install a personal firewall and

ONLINE ASSAULTS



Web Sites You Can **Trust** to Help

download.com Free download of Ad-aware and Spybot Search & Destroy

housecall.trendmicro.com Spyware information tools, tips, and vendor for Trend Micro software

mcafee.com Sells McAfee anti-virus and anti-spyware software

microsoft.com/athome/security/viruses Up-to-date Windows security patches and spyware-protection information

pcpitstop.com Free virus and spyware scans and other tools

spywarewarrior.com/rogue_anti-spyware.htm Lists software that may spread spyware

symantec.com/avcenter/ Spyware information tools, tips, and vendor for Norton software products

webroot.com Sells Spy Sweeper anti-spyware

zonelabs.com Free download for firewall

Personal Business

an anti-virus program. ZoneAlarm from Zone Labs is a free basic firewall. Symantec and McAfee sell popular personal firewall and anti-virus software. Until the anti-virus programs become more thorough in blocking spyware, which should be within the next year, it's imperative to use a separate anti-spyware program.

Next, set the computer's operating

system for daily security updates. Also set the Web browser to a medium- or high-security level. For Windows, go to Microsoft's Web site for instructions (table, page 109). Windows XP users should install Service Pack 2, which makes it close to impossible for software to be downloaded without your being alerted. Consider switching to a Macintosh computer

or a browser less popular than Internet Explorer, such as Mozilla Firefox (mozilla.org) or Opera (opera.com). They are less likely to be attacked.

Finally, practice safe surfing. This means downloading only trustworthy software, reading licensing agreements, avoiding banner ads, and deleting spam. In other words, just say no. ■

Spirits

Scotch at Supper

Here's a tasting with a difference: Single malts paired perfectly with food. **BY STEVE HAMM**

DINNERS AT WHICH A sommelier pairs a different wine with each course are common these days. But not long ago, I went to a tasting with a twist: The food was matched with six single-malt Scotch whiskies, each with its own fragrance and flavor.

The tasting took place in Pennsylvania Dutch country at The Farmhouse Restaurant in Emmaus. Bringing insider knowledge—and a little poetry—to the proceedings was the guest speaker, John Hansell, editor of *Malt Advocate*, a magazine for whisky aficionados.

Single-malt scotch is a curious thing. Most of it is distilled in a few villages in Scotland using ancient techniques. Each whisky is made in a single distillery from three ingredients: barley, yeast, and local water that picks up flavors by passing through heather and peat bogs. The water-soaked barley—or malt—is dried in a kiln over a fire that includes peat, giving the whisky a smokey flavor. It's aged, sometimes for 21 years or more, in oak barrels that previously held bourbon or sherry. The names of the distilleries add to the mystique: Glenmorangie, Bruichladdich, and Talisker, to name a few.

While this style represents less than 10% of all Scotch sold in the U.S., it has been gaining popularity over the past decade. Consumption of single-malt Scotch grew 7% last year, while overall

Scotch consumption shrank a bit, according to Adams Beverage Group, a spirits market researcher.

FOR PEAT'S SAKE

AT THE FARMHOUSE tasting, the whisky and food were extremely well matched. Pairings started with raw oysters and a couple of ounces of 12-year-old Old Pulteney, which had a fresh tangy smell and

tastes of caramel and vanilla. Next came puree of leek and potato with 10-year-old Auchentoshan, triple-distilled to make more refined. A 21-year-old Glenmorangie—smokey to “almost leathery,” said Hansell—accompanied a chèvre tart.

For the main course, we were served salmon filet on braised leeks and mussel herb champagne sauce with 15-year-old Bowmore. Hansell pulled out the stopper when describing the Bowmore, which comes from an island, Islay. Imagine, he said, that you go out on a fishing boat on Islay, fall into the net as you're pulling in a catch of fish, and dry out in front of a peat fire on the beach. “It's smokey, peaty, seaweedy, briny,” he said. Dessert was warm chocolate bread pudding with 12-year-old Glenfarclas, which tastes of sweet sherry.

The Farmhouse plans to repeat its Scotch-tasting extravaganza next June, on the Friday before Father's Day (610 967-6225). If you go, make a weekend of it and stay at Heritage House, a bed and breakfast in town. It's a great getaway less than two hours' drive from New York or Philadelphia. Plus, your taste buds will thank you. ■



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If Rates Are Up, Why Are Bonds?

Real estate and utilities funds also thrive. **BY LAUREN YOUNG**



IT'S NOT SUPPOSED TO HAPPEN this way. The Federal Reserve is hiking short-term interest rates, yet yield-oriented investments are thriving. In the third quarter (through Sept. 17), the total return of the average bond fund rose 2.74%, real estate funds gained 7.95%, and funds that specialize in utility stocks jumped 5.53%. Even funds holding financial stocks were up 2.83%. The gains caught many savvy mutual fund managers off-guard. "We really thought we'd see some pressure on bonds by now," says Robert Ostrowski, an 18-year veteran of the bond market who oversees \$24 billion in fixed-income

assets at Federated Investors.

Go figure. Equity funds should have done better. After all, the Fed doesn't raise interest rates in a weak economy. Yet diversified U.S. equity funds were down, on average, 2.5%—a showing worse than the Standard & Poor's 500-stock index's 0.8% loss. Large-capitalization value funds fared best, up 0.45%. Funds investing in growth stocks took a drubbing (table, page 114). And despite a late-in-the-quarter rally, technology funds declined nearly 11%. Fund data are calculated by Standard & Poor's, which, like *BusinessWeek*, is a

part of The McGraw-Hill Companies.

What's behind the strength in bonds? Some pros say hedge funds, using lots of borrowed money, are buying in quantities large enough to push prices higher and yields lower. "I haven't seen this kind of leveraged money in fixed-income since 1993-94," says Joe Deane, managing director of Citigroup Asset Management, who runs about \$7 billion in various fixed-income funds. That was a volatile period for the bond market—and not a good time for stocks, either. Deane predicts that bonds will be "extremely volatile" for the next two years. "It's a great time to be cautious," he adds.

Bond Funds Are Looking **Better**

FUND	TOTAL RETURN*	FUND	TOTAL RETURN*
Emerging Markets Bond	8.85%	Muni. Single-State Interm.	2.80%
Long Government	4.37	Muni. High-Yield	2.68
Long (General)	4.35	Intermediate Government	2.28
Multisector	3.66	International Bond	2.27
Muni. Calif. Long	3.64	Short Government	1.35
Muni. New York Long	3.46	Short (General)	1.21
Muni. National Long	3.43	Muni. Short	1.18
High-Yield	3.34	Ultrashort	0.52
Muni. Single-State Long	3.21	Convertibles	-0.83
Muni. New York Interm.	3.13		
Muni. Calif. Interm.	2.99	Municipal Bond Funds	3.03
Muni. National Interm.	2.93	All Bond Funds	2.74
Intermediate (General)	2.86	Taxable Bond Funds	2.50

*Annualized total return of dividends and capital gains before taxes, Aug. 1 to Sept. 17, 2004.
Data: Standard & Poor's

REAL ESTATE SAVVY

SOME WOULD SAY the same about real estate funds. After all, prices for land and properties remain strong in the face of higher rates. But Darren Rabenou, a member of the real estate team at J.P. Morgan Fleming Asset Management who oversees the \$160 million Undiscovered Managers REIT Institutional fund, isn't concerned. "[Real estate investment trusts] are enjoying the best of all worlds," says Rabenou, whose fund gained 8.1% in the quarter. The stock market can't get any traction, nor can bonds deliver much yield. Meanwhile, the real estate industry's fundamentals are improving. Occupancy rates are rising in the office and apartment sectors, and earnings industrywide are

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For Most Equity Funds, a **Weak** Quarter

FUND	TOTAL RETURN*	FUND	TOTAL RETURN*
Latin America	12.81%	World	-1.65%
Real Estate	7.95	Miscellaneous	-1.86
Diversified Emerging Markets	6.37	Mid-cap Value	-1.94
Natural Resources	5.69	Mid-cap Blend	-2.37
Utilities	5.53	All Cap	-2.45
Pacific/Asia ex-Japan	5.29	Small-cap Blend	-2.67
Financial	2.83	Health	-3.16
Precious Metals	1.93	Large-cap Growth	-3.70
Large-cap Value	0.45	Mid-cap Growth	-4.94
Europe	0.44	Small-cap Growth	-6.12
Domestic Hybrid	0.14	Japan	-9.05
International Hybrid	0.14	Technology	-10.95
Foreign	-0.92		
Communications	-1.22	All International Funds	0.12
Diversified Pacific/Asia	-1.23	Standard & Poor's 500	-0.78
Large-cap Blend	-1.23	All Equity Funds	-1.57
Small-cap Value	-1.65	U.S. Diversified Funds	-2.48

*Appreciation plus reinvestment of dividends and capital gains before taxes. Aug. 1 to Sept. 17, 2004.
Data: Standard & Poor's

picking up. To that end, Rabenou favors investments such as ProLogis Trust, an operator of distribution centers and warehouses, which is poised to benefit from an improving economy as companies stockpile more equipment, materials, and consumer goods.

Another strengthening corner of real estate is lodging. Ted Bigman, manager of the \$1 billion Morgan Stanley Real Estate Fund, which is up 9.32% for the quarter, likes Starwood Hotels & Resorts. The White Plains (N.Y.) company is concentrated in major urban markets, with brands such as Sheraton, St. Regis, and

W that cater to business travelers. Although companies haven't ramped up hiring, "business travelers have the green light again to go out and travel," Bigman says. Better exposure to the New York market, he says, separates Starwood from its competitors.

SHYING AWAY FROM SMALL-CAPS

THE ECONOMIC EXPANSION should give a lift to U.S. diversified funds, too, especially those that focus on big blue-chip names. "The underlying business backbone of Corporate America is getting stronger every day," says Robert Zagunis, co-manager of the \$2.4 billion Jensen fund. He's favoring megacap companies such as General Electric and pharmaceutical giant Pfizer.

Although large-capitalization growth funds declined by nearly 4% during the quarter, Zagunis is unfazed. After all, he knows a thing or two about the potential of an underdog: He's a former U.S. Olympic rower whose daughter Mariel won a gold medal in fencing at this summer's Olympics in Athens after nabbing a

slot on the U.S. team at the last minute.

If fund managers are bullish on big caps now, they're shying away from small-company stocks, which outperformed the broader market over the past few years. James Margard, lead manager for the \$380 million Rainier Small/Mid-Cap Equity Fund, is shifting his focus to midsize companies (\$2 billion to \$12 billion market caps) because that's where he is finding better deals with a lot less risk. One of the fund's largest holdings is Joy Global, a Milwaukee producer of mining equipment. Components account for two-thirds of sales at Joy Global. "There's a continuous flow of orders to replace worn-out parts," Margard says. Some 70% of Joy Global's business is linked to coal mining, and increased demand in China is driving much of those sales.

Beyond the U.S., more risky emerging market bonds, as well as Latin American stock funds, fared well during the quarter, rising 8.85% and 12.81%, respectively. Issuers of emerging-market debt and equities can thank fundamental economic changes in the past few years for the enhanced performance. Better balance sheets are luring David Antonelli, director of global equity research at Massachusetts Financial Services, and other investors to nations south of the border where countries have restructured their debt to more manageable levels.

Antonelli favors Mexico because of its close trade ties to the U.S. He sees improved performance for media operator Grupo Televisa, which dominates in Mexican broadcasting and is poised to benefit as advertisers spend more money. Antonelli, who manages the \$1.6 billion MF International New Discovery Fund, also is putting money to work in small and midsize Japanese companies. During the country's prolonged downturn over the past decade, companies cut costs sharply to stay afloat. Now that Asian markets are growing rapidly, demand is high, and "companies have tremendous leverage on the bottom line," he says.

One example is Japan's Seiko Epson, maker of electronic devices as well as printers, with net sales of 1.4 trillion yen (\$12.7 billion), which restructured and trimmed costs across its diverse business lines. "It's the classic blade-and-razor story," says Antonelli. "As sales of printers pick up, you make all the money on supplies and toners." He predicts that the company will see double-digit earnings growth during the next two years. Double-digit earnings for a Japanese company? Maybe this time, Japan's rebound is for real. ■

How the Big Funds **Fared**

FUND	ASSETS (BILLIONS)	TOTAL RETURN*
Vanguard 500 Index Inv.	\$76.6	-0.72%
Fidelity Magellan	62.4	-1.27
Investment Co. of America A	59.4	0.49
Washington Mutual Investors A	57.8	1.77
Growth Fund of America A	52.1	-1.99
Standard & Poor's Depository Rcpts.	42.5	-1.12
Fidelity Contrafund	37.5	-1.47
Income Fund of America A	36.1	1.92
Dodge & Cox Stock	35.6	-0.01
EuroPacific Growth A	31.2	-0.09

*Appreciation plus reinvestment of dividends and capital gains before taxes. Aug. 1 to Sept. 17, 2004.
Data: Standard & Poor's



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Why Value Still Beats Growth

Goldman's Eileen Rominger on the sector's historic edge and what she likes now.

ROMINGER "The woes at AOL are overblown"



VALUE STOCKS HAVE BEEN on a five-year roll, gaining an annualized 7.4% since 1999, vs. a loss of 3.8% for growth stocks. Can the trend continue? Eileen Rominger, chief investment officer for the value team at Goldman Sachs Asset Management, argues that you can still make money in this part of the market. Her group oversees some \$11 billion in institutional and private accounts as well as mutual funds. Personal Business Editor Lauren Young spoke with Rominger about value investing and some of her current stock picks.

Why are value stocks still dominant?

It shouldn't be surprising that value is outperforming growth. That's what it tends to do. When you look at the Russell 1000 Value and Russell 1000 Growth indexes, which are now 25 years old, value beats growth by three percentage points a year, on average. Economists Eugene Fama and Kenneth French, using their own indexes, show value beating growth by an average 2.6% a year over 75 years.

Are value stocks still a good buy?

On a price-to-book basis, value stocks are still trading at a 44% discount to their growth counterparts, which is pretty typical for the group. So they're not overvalued relative to growth stocks.

Are you avoiding any part of the value universe right now?

Telecom-service providers have not offered a great deal of value. Their returns on capital are weak and need to improve before the stocks will go up. Right now returns are probably deteriorating.

What companies look strong?

CIT Group is a bit of an orphan stock: It's not a bank, it's not a consumer-finance company. It had been owned by Tyco International, and even though the Tyco management never got involved in CIT, it tarnished [CIT's] credit ratings. The ratings agencies were overlooking the tremendous strength of its middle-market business-oriented lending. We thought their credit ratings would be upgraded—indeed they were. The cost of debt came down dramatically after the upgrade.

Any other examples?

RenaissanceRe Holdings is a reinsurance company with improved returns. Its return on equity is about 20%. It is literally in the middle of the storm, having all kinds of catastrophe policies in areas slammed by the hurricanes. It's selling at a p-e ratio of seven times this year's earnings, and there's a lot of volatility in the stock because investors are worried about this terribly tragic storm season. But they are better than others at assessing risk. It's not about coming through it unscathed. It's about coming through it in a stronger position than your competitors.

Why is Time Warner a big holding?

Investors' perception of the woes at AOL are overblown. Time Warner's cash flow continues to be quite strong. Cost cuts are in place, and any improvement in advertising will be positive for the stock. ■

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EDITED BY TODDI GUTNER

APPAREL

GLOVES FOR EVERY PURPOSE UNDER HEAVEN



A SLEW OF SPECIALTY GLOVES has come along to protect all the delicate hands and expensive manicures out there. Nylon nonstick **Regency Kneading Gloves** (above, right) let you work with bread and pizza dough without getting those sticky little pieces under your fingernails (\$3.99, thekitchenstore.com).

Bionic Gardening Gloves protect against dirt and scrapes. Developed by a hand surgeon who also designs batting gloves for baseball players, these sheepskin gloves offer snug support and full dexterity (\$40, gardenscapetools.com).

To take care of your mitts while in the yoga studio, **Yoga-Paws** (above, left) give your palms extra cushion in inverted positions such as downward dog (\$30, yogasyz.com). They are made from a nonslip material and perforated, similar to a yoga mat.

—Kate Murphy

TIME OFF

RICHARD NIXON PULLED mostly As and Bs in law school, but eked out Cs in trusts and family law. Rutherford Hayes pioneered the insanity plea in defending a killer. And while Woodrow Wilson

was “most terribly bored” studying law, Gerald Ford attended two other laws schools before graduating from Yale’s. Such tidbits grace the American Bar Assn.’s exhibit on the 25 lawyer-presidents. Some did better out of office: William Taft became a Supreme Court Chief Justice. **Abraham Lincoln, an overachiever his whole life**, handled 5,100 cases over 25 years. The exhibit, which opened on Sept. 20 at the ABA’s Chicago headquarters, is free (abanews.org).

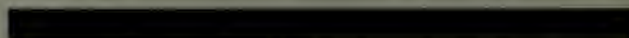
—Joseph Weber

TRUSTS

Private Guidance

SURE, YOU CAN'T TAKE it with you. But if you’ve established a trust fund for your heirs, you can have some influence over how the money is spent, even after you’re gone. You won’t have to fill your trust with instructions—a move that could open a can of worms, since beneficiaries generally can get access to the trust papers.

The trick is to write a side-letter to the trustee. Such a letter, while nonbinding, is an effective way to guide a trustee in how to make distributions. For example, if an heir has a substance abuse problem, you might ask the trustee to attach strings to the money. Likewise, you might want the trust to favor a disabled child. “There’s a better chance of keeping your wishes private this way than by putting them into the trust,” says James Ellis, managing director at **J.P. Morgan Private Bank**. One caveat: Although the trustee doesn’t have to disclose the existence of a side-letter, it could become public if the heirs file suit and request all relevant documents. To make sure no one misinterprets the side-letter as an amendment to the trust—which could create confusion, if not a lawsuit—get an estate lawyer to O.K. it. —Anne Tergese



SURVEYS

STILL TIME TO VOTE

IF YOU HAVEN'T filled out our airline survey at **BusinessWeek Online** (businessweek.com/go/airsurvey/), you haven’t missed out—yet. Answer by Oct. 3 a few short questions about your carrier preferences and priorities for choosing an airline, and you’ll be eligible to win a two-night stay at select properties of **Starwood Hotels & Resorts**. Results will appear in a special **Personal Business** report on business travel in mid-October.



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David Bernauer
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BY ROBERT BARKER

Dresser: The Halliburton Cast-Off That Could

Dick Cheney, vice-president and avid fly fisherman, doubtless tells a few tales of landing big ones. From his years as CEO of Halliburton, though, none was bigger than Dresser Industries, a venerable name in oil-field equipment and services that Cheney hooked back in 1998 with \$7.7 billion in Halliburton stock.

Soon, he began to cut Dresser up. One part, laden with asbestos liabilities, still haunts Halliburton, having plunged some units into a widely recounted, and ongoing, bankruptcy. The fate of another piece, which Cheney put up for sale in his last strategic move as CEO before leaving in July, 2000, to join the Republican ticket, is less well-known. Controlled now by a pair of private equity firms, the company, which kept the name Dresser, makes such sundry gear as natural gas engines, oil-field valves, and automated gas pumps for "pay-at-the-pump" filling stations. Halliburton, it turns out, might have been wiser to keep this part.

DRESSER NOW WANTS to sell stock in an initial public offering. While only rarely do IPOs merit individual investors' attention—the odds usually are stacked against them—Dresser may be an exception. With its execs keeping mum, we still don't know how much of the company's equity will be for sale or at what price. Yet when Dresser does disclose those key numbers, prospective investors will have much more information to evaluate them with than is usual for companies going public. That's because in 2001, when those private-equity firms, First Reserve and Odyssey Investment Partners, took over Dresser, they financed some of the deal with publicly traded junk bonds. So Dresser has had to disclose quarterly financial statements. It even conducts conference calls, which you can listen to via the Web (fulldisclosure.com).

Halliburton tossed back this part of Dresser because its focus on equipment manufacturing did not fit with Cheney's

emphasis on energy, engineering, and construction services. That did not slow Dresser, which traces its roots to Pennsylvania's oil fields of the 1850s and whose long list of customers includes the likes of ExxonMobil and BP. Sales kept growing, to \$1.8 billion in the latest four quarters (table), with a bigger share, 57%, coming from overseas markets, including India and China.

Dresser's backlog has risen 22% in the past year, to \$560 million.

This year, Dresser sees earnings before interest, taxes, depreciation, and amortization, or EBITDA, of \$180 million to \$200 million, or about twice last year's \$97 million (excluding a European energy distributor it bought in June).

As always, there are risks. While Halliburton indemnified Dresser from asbestos claims, and Dresser takes pains to disassociate itself from Halliburton, it faces its own political risk. In July, Dresser told Washington that the Dubai branch of one of its U.S. subsidiaries may have sold valves and other gear to Iraq, Iran, and Sudan without government authorization. What penalties it faces are unknown, but Dresser expects sales abroad won't be slowed.

In any case, Dresser will aim to get as much as it can for its stock in the IPO. What's it worth? One guide is the multiples of its competitors' sales and EBITDA. Cooper Cameron, a rival in oil-field valves, has an enterprise value (stock market capitalization plus net debt) of \$3 billion, or 1.6 times sales and 17.5 times EBITDA. Danaher, the other half of a global duopoly in high-tech gas pumps, trades at three times sales and 16 times EBITDA. At like multiples, Dresser's value, including net debt of \$1 billion, would range from \$3 billion to \$3.6 billion. Little more than three years ago, Halliburton let Dresser go for much less, just \$1.6 billion. ■

Dressed for Success?

Revenue	\$1,823
Operating income	91
Net loss	-21
EBITDA*	132
Net debt	1,011
Tentative symbol	DI

All data, in millions, for 12 months ended June 30. *Earnings before interest, taxes, depreciation, and amortization

Data: Company reports



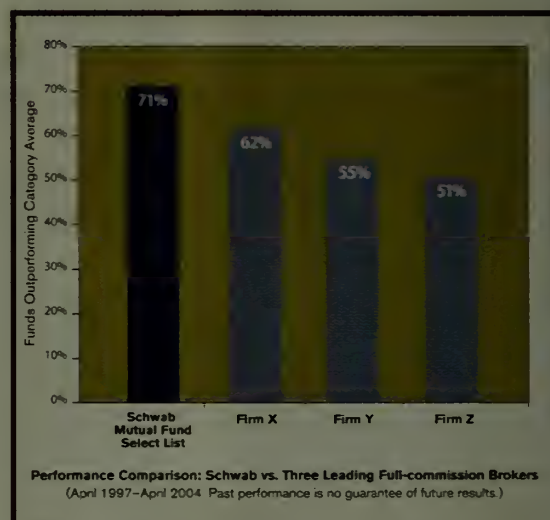
CASH MACHINE
Dresser's automated gas pump

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BY GENE G. MARCIAL

BOSTON SCIENTIFIC IS UPPING ITS STAKE IN ASPECT MEDICAL.

TRIPATH HAS A MARKETING DEAL FOR ITS CANCER DIAGNOSTICS.

BRAVE INVESTORS BET AGAIN ON ALLIANCE'S SLOT MACHINES.

A New Owner for Aspect?

ASPECT MEDICAL SYSTEMS (ASMP), a leader in brain monitoring technology, may be in play. So say some pros, who note that Boston Scientific has been buying Aspect stock in the open market since July—raising its stake to nearly 25%. The shares have leaped to 23, up from 13 in July. Through Sept. 17, Boston had paid 14 to 19 a share for some 600,000 shares of Aspect. A money pro at a hedge fund that owns shares (who doesn't want to be named) says Boston's buying pattern is a sign it's seeking control. Boston, with a market cap of \$32 billion, is best known for its drug-coated stent used for coronary-artery disease. It also makes minimally invasive devices used in cardiology. Suraj Kalra of Northland Securities, who tags Aspect a buy, says it's a good fit and would diversify Boston's revenues. Aspect's noninvasive monitoring system, called BIS, helps manage a patient's consciousness during surgery and administers the precise amount of anesthesia. Aspect has teamed up with Pfizer and Eli Lilly in clinical studies on the use of BIS in measuring the impact of antidepressant drugs and in the early detection of Alzheimer's. Kalra says that on fundamentals alone, Aspect is worth 23 but would fetch 30 in a buyout. He sees Aspect still in the red in 2004 but predicts earnings of 18¢ a share in 2005 on sales of \$62.8 million. Boston Scientific won't comment on the buyout talk. Aspect didn't return calls.



TriPath Imaging: The Prognosis is Good

ANOTHER DIAGNOSTIC OUTFIT that has caught the eye of investors is TriPath Imaging (TPTH), a maker of screening systems for Pap tests and other cancer-assessment products. Its stock, at 10 in April, slid to 7 in August but has since crept up to 8.30. "TriPath is an undervalued play in cancer diagnostics with its broad range of promising products," says Todd Robbins of T. Robbins Capital Management, which owns shares and invests mainly in medical stocks. Analysts are upbeat on TriPath's deals with major companies, expecting they will buoy earnings. William Bonello of Wachovia Securities says TriPath has lifted its forecast, expanded ties with No.1 Quest Diagnostics, and linked up with major

medical centers. In late September, TriPath will sign a pact with a major commercial laboratory to market to its physician clients TriPath's SurePath liquid-based Pap test for cervical cancer screening. On Sept. 16, TriPath granted Ventana Medical Systems world rights to sell a Ventana brand of its product. Bonello sees TriPath in the black in 2004 with earnings of 1¢ a share. In 2005, he sees a hefty 26¢.



Alliance Could Be 'The Comeback Kid in Vegas'

INVESTORS WHO GAMBLERED BIG on Alliance Gaming (AGI) in early April when its stock was flying at 34 a share have ended up as huge losers: The stock is now at 15. Except for a few brave souls, most analysts are sour on Alliance, the No.2 maker of slot machines. One courageous pro buying the battered stock is Jason Ader, an ex-gambling analyst and now CEO of Hayground Cove Asset Management. "Alliance is a turnaround story and will be the comeback kid in Vegas," says Ader, who figures the stock will get back to the mid-30s in a year. Investors bailed out of Alliance when it missed earnings forecasts in its fiscal fourth quarter ended June 30, 2004. A slowdown in casino expansion in Las Vegas, plus fierce competition, hurt earnings. But now Ader is hopeful that Alliance's new CEO, Richard Haddrell—seen as a turnaround ace, with a solid track record—will resuscitate the company. Jeff Martin of Roth Capital Partners sees demand for gambling devices picking up in 2005, based on increased Indian gaming, a Las Vegas rejuvenation, and more video lotteries at racetracks. Alliance has invested heavily in improving its machines to capture market share, says Martin. He sees earnings of 90¢ in fiscal 2005 and \$1.19 in 2006, vs. 85¢ in 2004. His 12-month price target: 22.

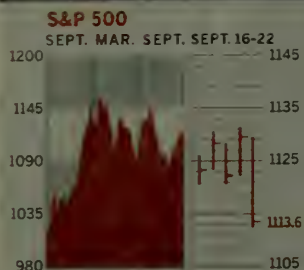


BusinessWeek online Gene Marcial's Inside Wall Street is posted at businessweek.com/today.htm at 5 p.m. EST on the magazine's publication day, usually Thursdays. See Gene on Fridays at 1:20 p.m. EST on CNNfn's *The Money Gang*.

Note: Unless otherwise noted, neither the sources cited in Inside Wall Street nor their firms hold positions in the stocks under discussion. Similarly, they have no investment banking or other financial relationships with them.

Personal Business Figures of the Week

STOCKS



COMMENTARY

Stocks, on the rise most of the week, fell sharply on Sept. 22, as companies began to report. Investors dumped shares of such outfits as FedEx and Bear Stearns, in spite of results that beat expectations. Meanwhile, bonds reacted perversely to the latest Fed rate hike, with prices firming and yields sinking. The markets are clearly worried despite the Fed's optimism.

Data: Bloomberg Financial Markets, Reuters

U.S. MARKETS

	SEPT. 22	WEEK*	% CHANGE YEAR TO DATE	LAST 12 MONTHS
S&P 500	1113.6	-0.6	0.1	8.9
Dow Jones Industrials	10,109.2	-1.2	-3.3	6.0
NASDAQ Composite	1885.7	-0.6	-5.9	0.6
S&P MidCap 400	587.1	-0.2	1.9	11.6
S&P SmallCap 600	287.6	-0.2	6.3	16.8
DJ Wilshire 5000	10,869.5	-0.5	0.6	9.5

SECTORS

	SEPT. 22	WEEK*	% CHANGE YEAR TO DATE	LAST 12 MONTHS
BusinessWeek 50*	648.1	0.0	4.2	10.3
BW Info Tech 100**	327.1	-0.5	-6.7	-0.1
S&P/BARRA Growth	539.1	-1.4	-3.0	3.3
S&P/BARRA Value	570.4	0.1	3.3	14.6
S&P Energy	275.1	3.6	22.7	39.5
S&P Financials	385.2	-1.3	1.4	10.6
S&P REIT	126.2	0.1	11.1	19.6
S&P Transportation	205.1	-0.3	1.6	13.2
S&P Utilities	127.4	0.9	7.6	16.0
GSTI Internet	145.6	-0.6	0.6	3.8
PSE Technology	676.9	0.5	-2.9	4.4

*Mar. 19, 1999=1000 **Feb. 7, 2000=1000

GLOBAL MARKETS

	SEPT. 22	WEEK	% CHANGE YEAR TO DATE	LAST MONTH
S&P Euro Plus (U.S. Dollar)*	1192.5	2.1	1.2	19
London (FT-SE 100)	4592.3	1.0	2.6	8
Paris (CAC 40)	3692.1	0.0	3.8	12
Frankfurt (DAX)	3942.4	0.0	-0.6	14
Tokyo (NIKKEI 225)	11,019.4	-1.2	3.2	5
Hong Kong (Hang Seng)	13,272.2	1.4	5.5	22
Toronto (S&P/TSX Composite)	8586.1	1.4	4.4	13
Mexico City (IPC)	10,777.2	1.1	22.5	3

FUNDAMENTALS

	SEPT. 21	WEEK AGO	YEAR AGO
S&P 500 Dividend Yield	1.69%	1.70%	1.62
S&P 500 P/E Ratio (Trailing 12 mos.)	20.0	20.0	28.9
S&P 500 P/E Ratio (Next 12 mos.)*	16.6	16.5	16.7
First Call Earnings Revision*	-0.49%	-0.23%	0.61

TECHNICAL INDICATORS

	SEPT. 21	WEEK AGO	READING
S&P 500 200-day average	1116.6	1115.0	Negative
Stocks above 200-day average	60.0%	59.0%	Neutral
Options: Put/call ratio	0.76	0.77	Positive
Insiders: Vickers NYSE Sell/buy ratio	3.65	3.37	Negative

BEST-PERFORMING GROUPS

	LAST MONTH %		LAST 12 MONTHS %
Casinos	14.2	Steel	88.2
Internet Software	13.4	Internet Software	77.7
Oil & Gas Drilling	12.9	Oil & Gas Refining	75.0
Homebuilding	11.8	Homebuilding	65.1
Oil & Gas Equipment	9.6	Internet Retail	64.1

WORST-PERFORMING GROUPS

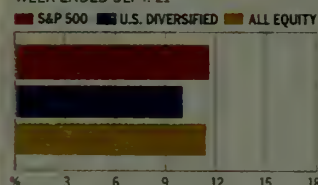
	LAST MONTH %		LAST 12 MONTHS %
Tobacco	-6.4	Airlines	-28
Home Entertainment	-5.8	IT Consulting	-27
Soft Drinks	-5.7	Semiconductor Equip.	-19
Brewers	-5.6	Semiconductors	-19
Environmental Services	-5.5	Health-Care Distribtrs.	-17

MUTUAL FUNDS

4-WEEK TOTAL RETURN



52-WEEK TOTAL RETURN



Data: Standard & Poor's

EQUITY FUND CATEGORIES

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		LEADERS	
Natural Resources	10.1	Natural Resources	40.1
Diversified Emerg. Mkts.	8.2	Latin America	35.3
Pacific/Asia ex-Japan	7.8	Diversified Emerg. Mkts.	25.4
Latin America	6.9	Real Estate	25.4
LAGGARDS		LAGGARDS	
Japan	0.0	Technology	-4.5
Real Estate	1.0	Precious Metals	0.7
Miscellaneous	2.5	Small-cap Growth	3.9
Domestic Hybrid	2.5	Large-cap Growth	4.8

EQUITY FUNDS

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		LEADERS	
ProFunds Energy Ushr. Inv.	18.7	ProFunds Energy Ushr. Inv.	65.2
American Heritage Growth	16.7	iShares MSCI Austria Idx.	61.6
Winslow Green Growth	13.3	State St. Rsch. Gl. Rs. B	60.4
Fidelity Select Nat. Gas	13.3	Bruce	55.3
LAGGARDS		LAGGARDS	
ProFds. USh. Sm. Cap Inv.	-11.3	Thurlo Growth	-34.9
Rydex Dyn. Vent. 100 H	-9.4	GMO Asia III	-34.5
ProFunds UltSh. OTC Inv.	-9.4	Ameritor Investment	-32.4
ProFds. USh. Mid Cap Inv.	-7.9	ProFds. Smicdr. Ultsr. Inv.	-31.7

INTEREST RATES

KEY RATES

	SEPT. 22	WEEK AGO	YEAR AGO
Money Market Funds	1.14%	1.09%	0.61
90-Day Treasury Bills	1.71	1.66	0.93
2-Year Treasury Notes	2.47	2.48	1.60
10-Year Treasury Notes	3.99	4.16	4.14
30-Year Treasury Bonds	4.77	4.96	5.03
30-Year Fixed Mortgage †	5.47	5.68	5.90

*Barr'sQuote Inc.

BLOOMBERG MUNI YIELD EQUIVALENTS

Taxable equivalent yields on AAA-rated, tax-exempt municipal bonds, assuming a 30% federal tax rate.

	10-YR BOND	30-YR BOND
General Obligations	3.4	4.5
Taxable Equivalent	4.96	6.50
Insured Revenue Bonds	3.65	4.78
Taxable Equivalent	5.21	6.83

THE WEEK AHEAD

NEW RESIDENTIAL SALES

Monday, Sept. 27, 10 a.m. EDT » New single-family home sales in August are expected to have increased to an annual rate of 1.15 million, from 1.13 million in July. That's based on median forecast of economists surveyed by Action Economics. The retreat in mortgage rates this summer has helped keep home buying strong.

CONSUMER CONFIDENCE

Tuesday, Sept. 28, 10 a.m. EDT » The Conference Board's

September confidence index probably eased down to 98, after tumbling to 98.2 in August.

PERSONAL INCOME Thursday, Sept. 30, 8:30 a.m. EDT

» August personal income most likely increased by 0.4%, after a 0.1% gain in July. Consumer spending is expected to have slowed to a 0.1% gain during August, after jumping by 0.8% in the prior month.

VEHICLE SALES Friday, Oct. 1

» Sales of U.S. and imported vehicles most likely rose to an annual rate of 17 million in September, aided by a late Labor Day holiday. Sales dropped to a pace of 16.6 million vehicles in August.

PURCHASING MANAGERS' INDEX Friday, Oct. 1, 10 a.m. EDT

» The Institute for Supply Management's September factory activity index probably fell to 58%, after declining to 59% in August.

The *BusinessWeek* production index increased to 227.9 for the week ended Sept. 11, a gain of 13.5% from a year ago. Before calculation of the four-week moving average, the index slipped to 227.6.

BusinessWeek online

For the BW50, more investment data, and the components of the production index visit www.businessweek.com/magazine/extra.htm

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W. B. Hopkins, Senior Vice President of Operations

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The New Earnings Game

ACCRUAL ACCOUNTING IS the heart and soul of corporate financial reporting. It encourages companies to make estimates of a wide variety of key financial variables and allocate revenue to specific quarters or periods of time. Accrual accounting allows companies a great deal of flexibility, which is appropriate. But it can also be a problem. Too many companies are taking advantage of that latitude to push their estimates to the limits in order to boost earnings. Most of it is perfectly legal, but that's no solace to investors who are left to decipher hidden, confusing assumptions and judgments made in reported earnings. Despite all the recent accounting reform, more work remains to be done. Companies have to clean up their financial statements to give investors transparent and consistent financial data or prepare to be punished in the market. Wall Street is already catching on to the shenanigans on income, balance-sheet, and cash-flow statements (page 78).

Companies can play lots of games, even with cash. Some businesses designate certain stocks they hold as trading instruments to inflate operating cash flow when the securities are sold. Many lead and lag payments to raise short-term cash

flow. Others lowball customers' bad debts to increase earnings and artfully adjust estimates of old inventories, receivables, and pension fund profits.

Ironically, it doesn't do companies any good in the long run. Research by Richard G. Sloan of the University of Michigan Business School and Scott Richardson of the

Overstating estimates doesn't do companies any good in the long run

Wharton School shows that companies making the largest estimates and reporting the most exaggerated earnings initially do well. They attract lots of investors, and their stocks soar. But later, when the estimates prove overstated, their stocks tank. Indeed, the shares of companies that overstate their estimates, on average, lag the stocks of similar-sized companies by 10 percentage points a year.

This costs investors more than \$100 billion in market returns. These too-aggressive companies also have more earnings restatements, Securities & Exchange Commission enforcement actions, and accounting-related lawsuits.

What to do? Companies should make sure all the estimates and judgments in reported earnings are transparent. They should simplify their financial statements to make them clear and comparable. And at the least, they certainly need to report income and cash flow for the same time periods. Clarity and honesty in accounting would not only make the financial markets more efficient but also might head off a second round of corporate scandal and regulation. Does anyone want Sarbanes-Oxley, Part II?

A Smarter Policy For Immigration

THE WORLD'S BEST AND brightest are being kept out of America by ill-conceived, poorly implemented measures to thwart terrorism. Students who want to study, scientists who want to do research, and skilled legal immigrants who want to work can't get in. No one can question America's right after September 11 to keep potential terrorists from crossing the border. But any policymaker trying to promote economic growth and any CEO attempting to spur innovation and profits should be deeply concerned about the downturn in the numbers of educated, skilled foreigners moving to America. It's time for the U.S. to restructure its visa and immigration policies (page 90).

Witness the shocking statistics: The number of student

visas issued by the U.S. dropped 25% in 2002 and 10% last year, according to a new Homeland Security report, the 2003 *Yearbook of Immigration Statistics*. Some 35% of all student visa applications were rejected outright in 2003. The total number of immigrants granted the right to stay in the U.S. fell 24% in 2003. The number of foreigners with advanced degrees or exceptional skills allowed into the U.S. dropped by 65%, to 15,459, last year.

The State Dept. must hire more officers who speak foreign languages to fill their consulates overseas. Since September 11, students must wait months, if not years, to pass tougher screening. Having more officials to interview students would speed the process. For scientists and engineers with proven reputations, multiple-entry, long-term visas are the ticket.

The hardest challenge facing the U.S. is reshaping immigration policy for the 21st century. In 2003, 70% of the more than 700,000 legal immigrants were family-sponsored up from 63% the year before. Only 12% of admissions were for skilled workers, down from 16% the year before. A more judicious policy, with half the slots going to skilled workers and professionals, would strengthen America's competitiveness, promote entrepreneurship, and boost growth. Unless the U.S. changes its immigration policies, it risks losing the world's sharpest minds to those countries more willing to welcome them. That would be a shame.



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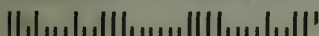
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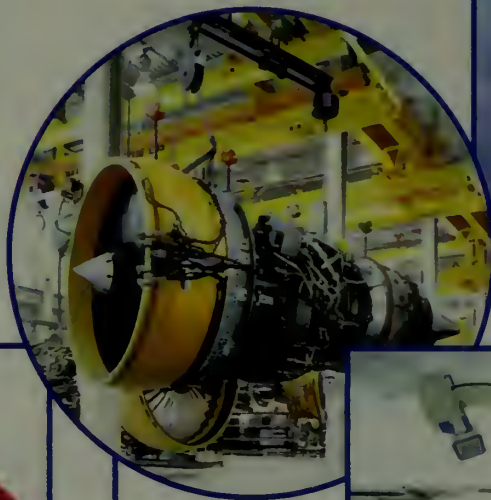
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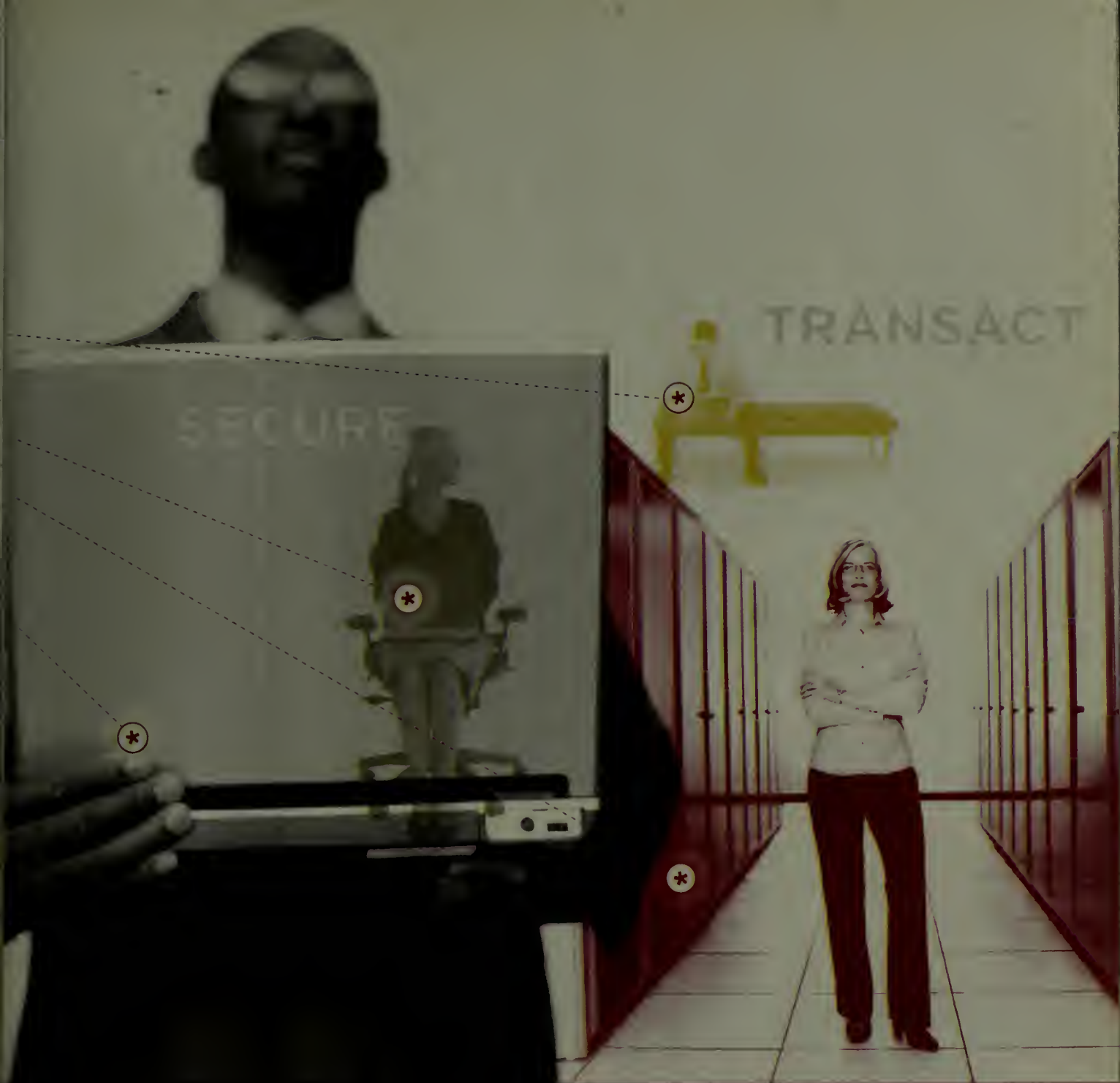
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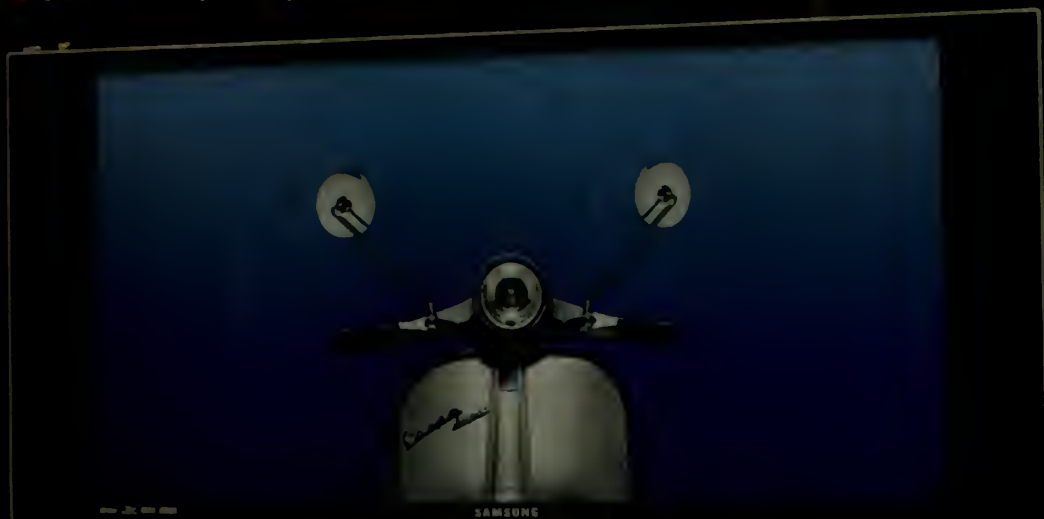
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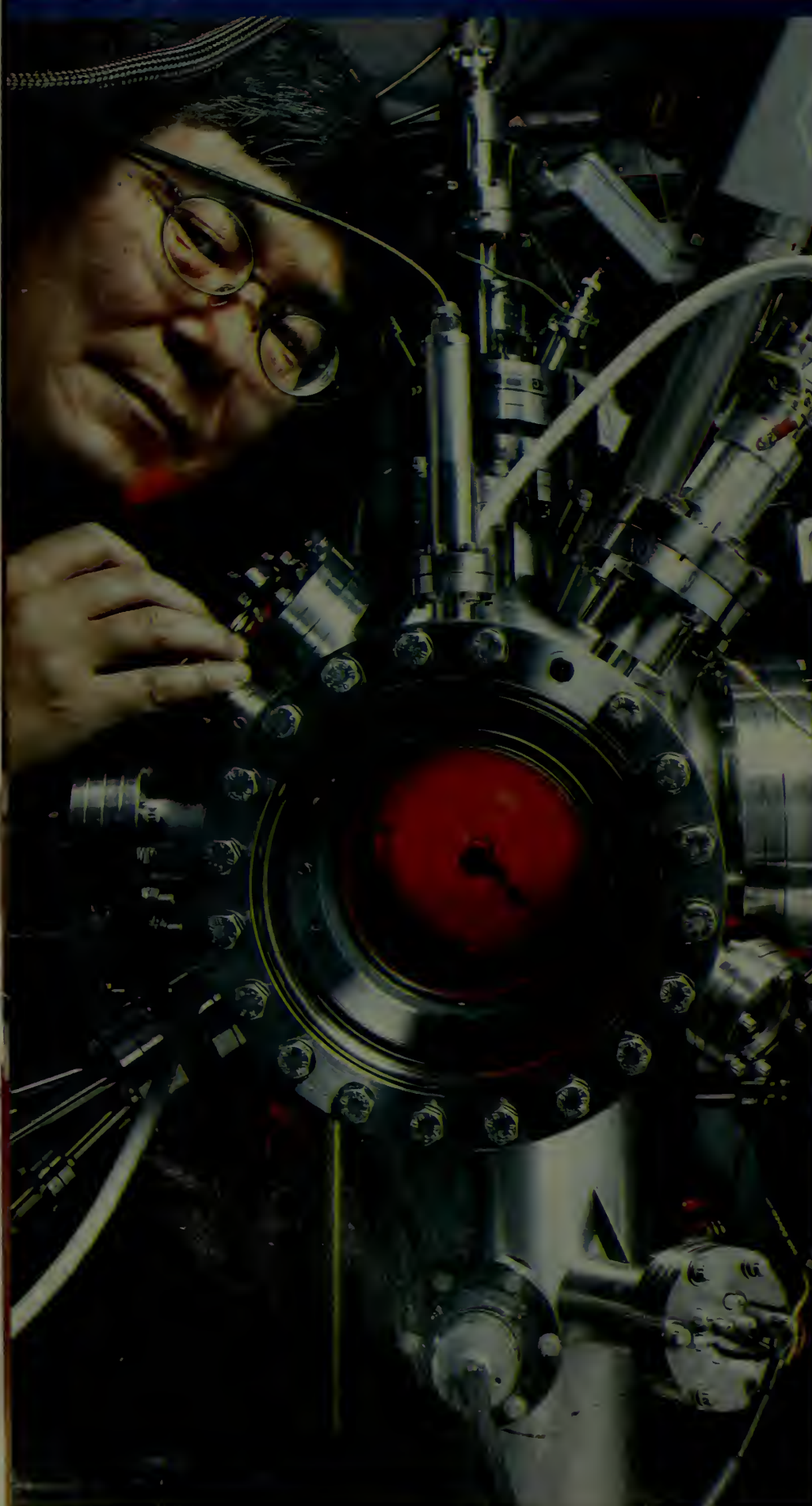
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The Innovation Economy

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75 YEARS IN COVERS

A snapshot history that spans the Great Depression to September 11, Radio Days to the Internet Age—and beyond. For *BusinessWeek's* diamond anniversary, we've assembled a decade-by-decade collection of covers that chronicle the significant trends and events that have transformed business

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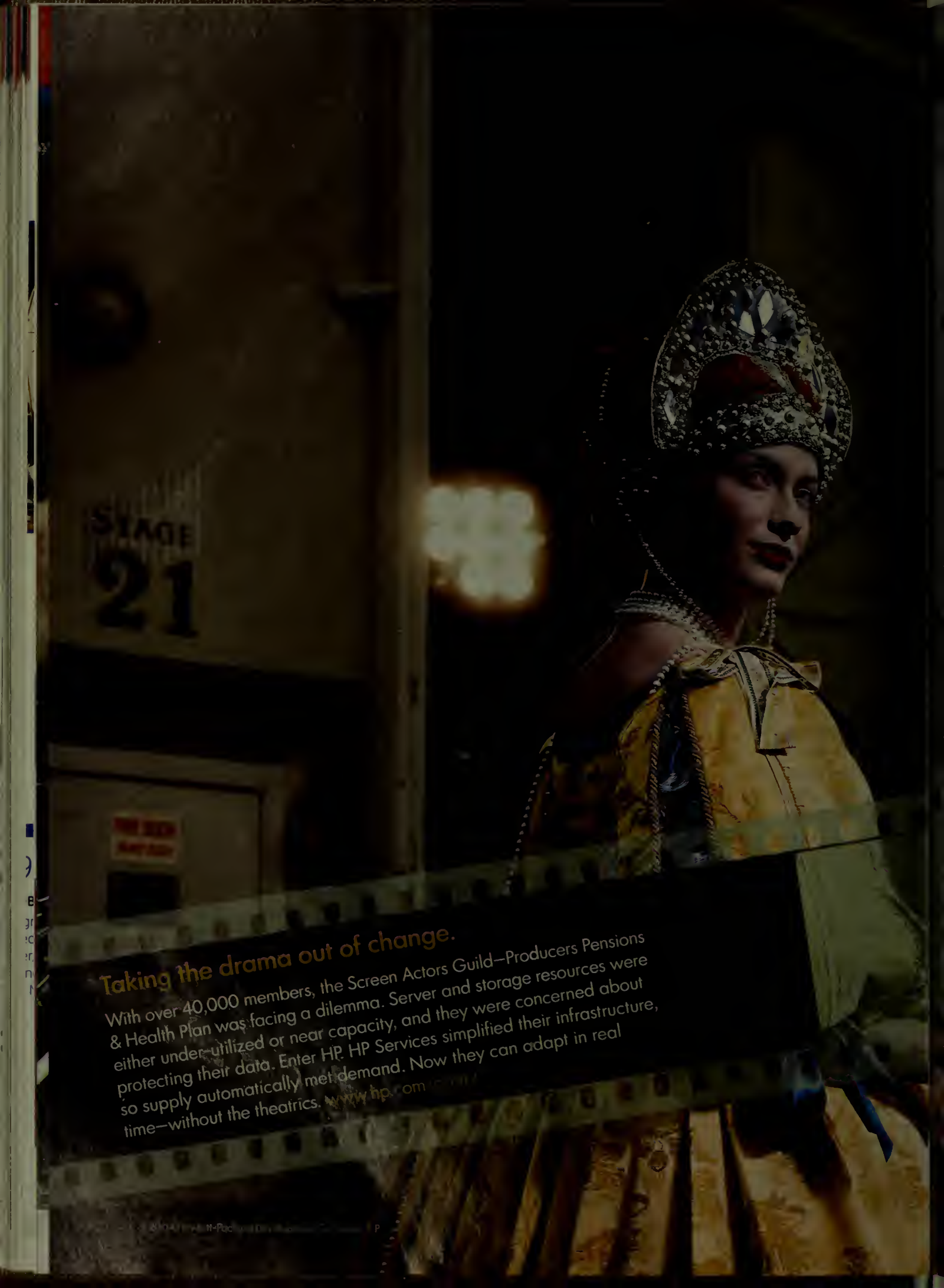
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When it came to our tasting of "white goods," the superpremiums ruled the day. Here, our top three in each category, plus our tasters' comments:

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Corporate America's Top Five Turnaround Busts.

This year has been a trying one for companies looking to make a comeback. But for this select bunch, attempts to regain lost glory have not only been disappointing, they have fallen flat

Still Waiting for the Spending Rebound

Even amid Wall Street's recent jitters about profits, U.S. corporate earnings have been growing at a solid pace. Investment, however, hasn't kept up. But that gap has closed recently, and continued growth should loosen the purse strings

A Wide World of Wheels from The Paris Motor Show

Aside from the usual flat-out Ferraris, the 2004 edition is all about "crossover" vehicles for Europe. Plus: An online slide show highlights our correspondents' favorite new offerings

Health Care: The U.S. Can Afford It

Those who say U.S. medical spending is too high have it backward. Living longer, better lives allows workers to be more productive. The economic and quality-of-life benefits from increased spending on health care will more than pay for themselves

Some Answers for Scammed Mutual Fund Investors

If your fund was snared in the market-timing scandal, here's why it may be quite some time before that restitution check is in the mail

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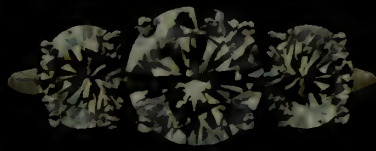
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"Now that was fun."

—Michael Melvill, pilot of the first private space flight, after his plane (photo, pages 90-91) rolled over unexpectedly several times near the top of the flight trajectory

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UNION DUES SCUFFLES IN THE LABOR RANKS

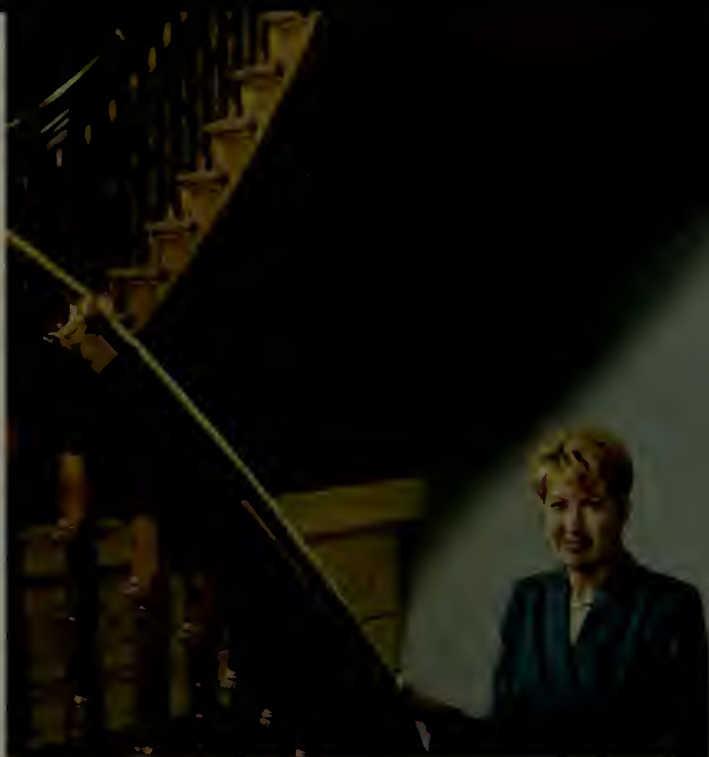
THE AFL-CIO headed for a peakup on its 50th anniversary next year? The possibility jumped sharply on Sept. 27, when the 30,000-member International Association of Machinists (IAM) authorized its leaders to yank the union out of the AFL-CIO if they can't fit. The resolution comes in response to a campaign by Service Employees Union President Andy Stern and other officials to shake up the labor federation by creating fewer, more powerful mega-unions. IAM President Tom Buffenbarger's primary fear,

sources say, is all the talk of changing the AFL-CIO constitution next year to allow it to force mergers between member unions. That could revive pressure for an ambitious merger scheme that Buffenbarger's predecessor had signed on to with the auto workers and the steelworkers, which collapsed in 1999. "We need to send a strong message to the AFL-CIO: We should not allow our own dues dollars [to the AFL-CIO] to

be used against us," Buffenbarger told delegates.

Other unions, especially the 40-odd smaller ones that would be likely merger candidates, could be emboldened to follow IAM's lead. The AFL-CIO

declined to comment. Looks as if the federation's anniversary will be a hot one. —Aaron Bernstein



EXECUTIVE SUITE

HP Puts Out A Call for Help

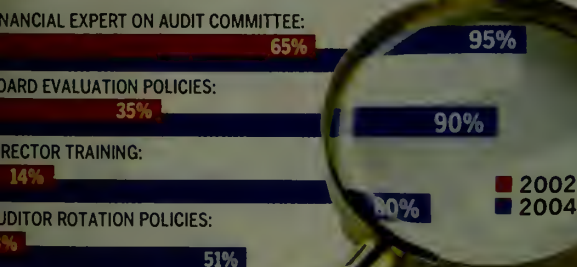
WHEN HEWLETT-PACKARD missed its third-quarter earnings expectations by 39%, it blamed the unit that sells gear to corporate customers. Now the company is quietly trying to bring in some new managers, including a senior operations executive, to help CEO Carleton Fiorina (above) fix the business, *BusinessWeek* has learned.

Recruiter **Spencer Stuart** has been conducting the search for a top-level services executive and a marketing vice-president. Several **IBM** execs have been approached, according to sources. Potential candidates are being told that, after a transition period, the services chief could take over all enterprise services, hardware, and software operations. HP Executive Vice-President Ann Livermore was recently given those duties; it's not clear what role she would eventually assume. Candidates for the marketing job have been told that it calls for retooling the company's overall marketing and image. HP declined to comment.

According to sources, HP also is looking for a seasoned exec to run day-to-day operations across its units that sell to corporations, including enterprise hardware and software, services, and PCs. This new hire would report to Fiorina. —Ben Elgin

THE BIG PICTURE

PROGRESS Since passage of the Sarbanes-Oxley Act, more U.S. companies have implemented the following governance reforms:



Source: Governance Metrics International

WEB WATCH

CENSORSHIP: BEIJING 1, GOOGLE 0

WHEN GOOGLE went public in August, its founders vowed they would hold the customer experience sacrosanct. Yet the company has voluntarily excluded Web sites banned by government censors on a service recently launched in China to search Chinese-language news outlets. In stark contrast, the company refused to alter its searches in 2002, when the Chinese government briefly banned Google.

The search kingpin admits to removing eight news sources, apparently deemed subversive, from the Chinese site, which is still in a test

version. "In order to create the best possible search experience for our mainland China users, we will not include sites whose content is not accessible," says a Google spokesperson (for Google's potential move into browsers, see page 54).

Aside from the censorship itself, Google offers China users an uncharacteristic lack of disclosure on the removed content. It notifies U.S. users, for instance, when copyrighted content has been removed from searches. In China, Google doesn't disclose the modifications.

Rival **Yahoo!** has long conformed to censors in its own Chinese site. Google says China's imminent position as the world's most populous—and potentially lucrative—Internet market had no role in the decision. —Ben Elgin



SHOW BIZ

BRAIN WAVES Walt Disney is trying to replace longtime partner Pixar Animation Studios by ramping up its own computer animation, but its Miramax Film unit has its own plans. **BusinessWeek** has learned that **Dimension Films**, a unit of Miramax, has signed a five-film deal with **Wild Brain**. The San Francisco animation house is best known for **Digger** (above), a critter that burrows under toenails in ads for Novartis' foot-fungus remedy. If Disney can't persuade Pixar to re-up—and talks have gone nowhere—Miramax founders Harvey and Bob Weinstein, who are also tussling with Disney, might just show up the parent company with their own animation hits. Up first for consideration is a flick based on **Opus**, the penguin of **Bloom County** comic strip fame. —Peter Burrow

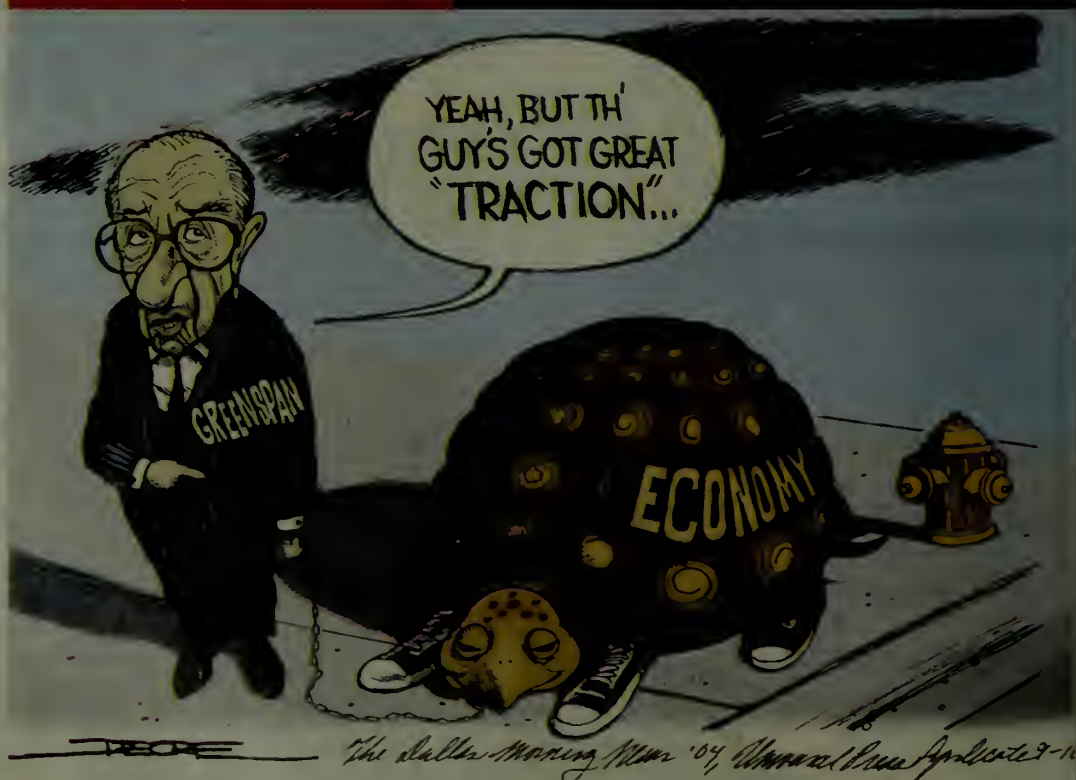
AFTER 9/11

HOW DO YOU STACK UP ON SECURITY?

ARE U.S. COMPANIES ready for disaster? A **Harris Interactive** poll of execs at top companies found only 58% felt they were set up for better access to critical data in a catastrophe than they had been on September 11, 2001. That's down from 67% last year.

Yet when asked to grade their readiness, the executives gave themselves a B, up from C+ the year before. Jim Simmons, CEO of **SunGard Availability Services**, which commissioned the survey, says execs gave themselves extra points for knowing their weak spots. That's progress, of a sort. —Diane Brady

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FACE TIME

DAWN LEPORE



TAKING ON AN ONLINE DRUGSTORE

Dawn Lepore was Charles Schwab's chief information officer from 1993 to 2001, when the brokerage's electronic trading boomed. Later, as vice-chairman, she endured a "couple of tough years," she says. Co-CEO David Pottruck left under pressure in July. Now, Lepore is heading for the door, too. On Oct. 11, she joins drugstore.com in Bellevue, Wash., as chairman and CEO.

It won't be any easier at the only online health-products shop to survive the dot.com bust. Not many consumers use the Web to buy toilet paper and shampoo. Prescription volume will grow as boomers gray, but the site has many competitors—including low-priced Canadian outfits. While revenues in 2004 will rise 44%, to \$350 million, the company is still in the red.

Yet Lepore, 49 and a mother of two, is banking on the efficiency of online shopping and the company's stock of hard-to-find items. "Those demands will continue to drive growth," Lepore, for one, is already a customer. —Amy Tsao

ON THE ROAD

A PAVED, WELL-LIGHTED CAMPSITE

THERE ARE NO CAMPFIREs in the Wal-Mart parking lot in Concord, N.H., only security cameras and lights that never shut off. But pass by any evening, and you'll see recreational vehicles dotting the asphalt, taking advantage of what has become America's fastest-growing free RV way station. "You can't always find a campground or a place that will be safe to pull over," explains Tom Fayette, a traveling preacher who was among a dozen camped at the Concord Wal-Mart.

RV aficionados have used Wal-Mart Stores lots as impromptu rest stops for years, owing to their safety, ubiquity, and convenience. But the practice has exploded in the past three years, says Chuck Woodbury, editor of online newsletter *RV Travel*. With more RVers on the road and the recent run-up in gas

WAL-MART



CONCORD, N.H. Sleeping over at Wal-Mart

prices, Wal-Mart lots are a welcome oasis.

Wal-Mart doesn't have an official stance on the practice. Local laws prevent about 10% of its 3,200-plus U.S. stores from adopting an RV-friendly policy. "We don't offer sewer hookups or anything like that," says Wal-Mart spokeswoman Sharon Weber. "But we do offer [the open lot] as a convenience when we can." Weber says some stores see up to 100 campers a night. Wal-Mart even sells a special Rand McNally atlas complete

with directions to every store and notes as to which ones have pharmacies, full groceries, or other services.

Purists wouldn't call it camping, but on a recent night in Concord, Wal-Mart was a temporary home for Fayette, as well as retirees from Quebec, itinerant laborers from northern New Hampshire, and visiting Texans. All in the shadow of a 24-hour superstore selling everything from live lobsters to porcelain eagle statuettes—not to mention those road maps guiding you to the next Wal-Mart. —Eric Moskowitz

CULTURE CLASH

I'M SO MAD I COULD JUST... WORK

DELTA AIR LINES' recent announcement of pay and benefit cuts must have rankled workers. But could such anger-inducing moves have a beneficial effect? Maybe so. Research by Jennifer George, a management professor at Rice University, finds that bad moods can spark creativity.

George, working

with Jing Zhou of Texas A&M University, studied designers and engineers at a large helicopter manufacturer. Workers with good moods often felt that they had made progress and their efforts had been sufficient. Negativity signaled discontent with the status quo and spurred solutions to problems.

George doesn't suggest that companies purposely try to tick off workers. But it's helpful to realize that "sometimes those feelings are functional," she says. So have a nice day! Or don't.

—Brian Hindo



MOE The Three Stooges' grouch

THE STAT

13

The percentage rise in total compensation, to an average of \$176,000, for directors on the 200 largest companies' boards in 2003.

Data: Pear Meyer & Partners

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The Great Innovators

CELEBRATING

75

As part of its anniversary celebration, BusinessWeek is presenting a series of weekly profiles of the greatest innovators of the past 75 years. Some made their mark in science or technology; others in management, finance, marketing, or government. This week, BusinessWeek publishes a special commemorative issue on Innovation.

Three Wise Men of Finance

IF YOU'VE EVER put money in an index mutual fund, you can thank three economists—Harry Markowitz, William Sharpe, and the late Merton Miller. Such funds are the best-known application of research they did in the 1950s and '60s. Their work won them the Nobel prize for economics in 1990 and changed the way investors and managers think about markets, money management, and securities design. Key concepts in investing and corporate finance that are today accepted as obvious can be traced back to their articles in scholarly journals—everything from the existence of a systematic trade-off between risk and return, to the concept that markets are efficient.

Markowitz, a self-described nerd whose father was a Chicago grocer, set the ball rolling. In 1952, the University of Chicago economist published a 14-page paper called "Portfolio Selection." At its heart was what Peter Bernstein, dean of financial economists, called "the most famous insight in the history of modern finance"—the idea of diversifying a portfolio of stocks in order to produce the maximum potential returns given the amount of risk an investor is prepared to take on. Of course, the notion of not putting all one's eggs in the same basket had been a truism for centuries. (It's mentioned in the Talmud and Shakespeare among other places.) Markowitz proved why this is so by explaining the fundamental trade-offs between risk and return and between asset concentration and diversification. Money managers around the world still follow his precepts daily.

Markowitz' early work sparked a long period of intellectual

ferment. In the process, Markowitz, Sharpe, and Miller demolished many cherished Wall Street ideas. One example: that it's possible to beat the market consistently by savvy stock picking. Impossible, they said—because thousands of investors collectively have factored everything that is known about stocks into current prices.

Sharpe, a charming if sometimes blunt computer whiz, devised the capital asset pricing model (CAPM), which quantified the idea that investors demand extra returns for taking on more risk. Souped-up versions of the CAPM are still used widely in business to guide investment decisions. Miller, a passionate defender of futures markets, developed, with Franco Modigliani, the MM Proposition. They showed that any company's worth depends on its earning power rather than its book value. So, if there's a tax break on interest payments, savvy companies should favor debt over equity. That insight was a real shocker to a Wall Street steeped in the cult of the equity. It provided the intellectual heft that led to the surge in the junk bond markets in the '70s. Leveraged buyout, anyone?

There were some failures. A few techniques developed from their ideas by Wall Street rocket scientists proved disastrous: So-called portfolio insurance was partly to blame for the 1987 stock market crash.

Now, a new generation of financial economists is challenging the work of Miller, Sharpe, and Markowitz, often improving on it. But it's the Nobel trio who helped turbocharge global capital markets. ■

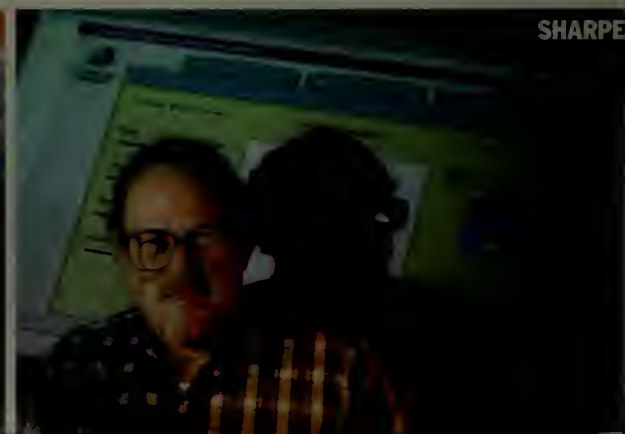
—By Christopher Farrel

Their insights into the links between risk and return revolutionized investing forever

MILLER

MARKOWITZ

SHARPE



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Thomas Cook

High-performance operations, delivered.

A 163-year-old brand with many owners over the years, Thomas Cook UK & Ireland was a respected but complex, decentralized travel services business in need of a return to profitability. In an innovative co-sourcing arrangement with Accenture, the company created a shared services center to consolidate its widely dispersed IT, finance and HR administration operations. Responsibility for strategy and policy was retained by Thomas Cook, with Accenture facilitating operations management. In 16 months, the company removed £140 million in operational costs, helping to achieve an £83 million turnaround, establishing Thomas Cook as a high-performance player in the competitive UK travel business.

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A Time to Celebrate

Anniversaries are always a time to reflect—and to look ahead. The first issue of *BusinessWeek*, on Sept. 7, 1929, appeared just seven weeks before the stock market crash that ushered in the Great Depression—hardly an auspicious moment to start a business magazine. And in our bones, we seemed to know that trouble lay ahead. In the magazine's very first Business Outlook section, we wrote: "Stock prices are generally out of line with safe earnings expectations, and the

market is now almost wholly 'psychological'... properly apprehensive of the inevitable readjustment that draws near."

Yet we thrived and prospered, in part because of the editorial vision that was established on Day One. As Malcolm Muir, president of McGraw-Hill Publishing Co., put it: "*The Business Week* [as it was called then] will never be content to be a mere chronicle of events. It aims always to interpret their significance.... *The Business Week* always has a point of view, and usually a strong opinion, both of which it does not hesitate to express. And all the way through, we hope you will discover it is possible to write sanely and intelligently of business without being pompous or ponderous."

We've stuck to our founders' wise vision, some 3,903 issues later. You can see some of the excitement reflected in our photo gallery of 75 years of *BusinessWeek* covers, which begins on page 73.

FOR OUR 75TH ANNIVERSARY ISSUE WE DECIDED to focus on innovation. Why? Because technological change has been such a prominent feature of the business and economic landscape during our lifetimes. It has been critical to *BusinessWeek's* coverage from radio days to the Internet Age. And we believe the years ahead could well bring an era of innovation surpassing the one that brought us antibiotics, jet travel, television, and computers. You'll find many of the possibilities in the pages that follow in our special report, "The Innovation Economy."



1929-2004 For 75 years technological change has dominated the business landscape. This issue looks ahead to the future of innovation



This anniversary issue is the joint effort of more than 80 *BusinessWeek* staffers from around the world under the direction of Assistant Managing Editors Bob Dowling and Frank Comes. My thanks also to Rose Brady, Don Besom, Neil Gross, Mike Mandel, Larry Lippmann, and Jay Petrow for their special contributions.

So after a brief moment for celebration, please join us in looking forward to the next many years. It promises to be a great ride.

Stephen B. Shepard

EDITOR-IN-CHIEF

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A large white swan is swimming in a pond, facing right. In the foreground, three small ducklings are swimming towards the viewer. The background is dark and out of focus.

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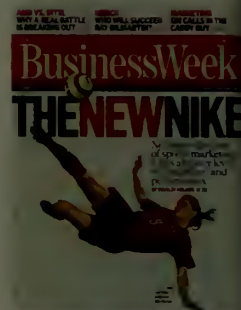
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There was once a major country that combined a small income tax with a large consumption tax...the Soviet Union."

—John E. Ullmann Hempstead, N.Y.



DESPERATELY SEEKING FAIRNESS IN TAXES

"WHAT A 'FAIRER' tax code might look like" expressed concern that "the rich" would have an unfair advantage under a consumption tax because they might not spend as large a share of their income as the rest of us do (*News: Analysis & Commentary*, Sept. 20). But what will the rich do with the money they don't spend? I expect they would put it to work either expanding their businesses, or they might use it as venture capital, and so help create businesses, thereby increasing the number of jobs and improving the national economy.

One other debt we owe the rich (if you will permit the expression) is that they provide the necessary first market for new products—indoor bathtubs, television, computers—so that manufacturers can make more at lower prices. Before too long, we all have these things.

—Elizabeth Mudge Mann
 New London, N.H.

WHY IS IT NEVER pointed out that the corporation exists as a separate entity and as such protects the investor from a loss greater than the initial investment? That

is the reason for the supposed double tax. If dividends were to pass through and not be taxed at the corporate level, in effect you have a partnership and all partners (shareholders) should be held personally responsible for all losses.

You should not be able to have it both ways. Already, taxes are evaded because companies hoard cash instead of declaring dividends, allowing individual shareholders to pay lower taxes by taxing capital gains on a sale of stock shares rather than paying tax on a dividend. The same profit from ownership is realized either way, but not the same tax.

—Robert Hendrickson
 Shickley, Neb.

YOUR LIST OF PROPOSED changes in the tax code if President George W. Bush were reelected conspicuously omits an old Republican gleam in the eye—i.e., to end the deductibility of state income taxes from the federal tax. When Senator Robert Packwood (R-Ore.) helped the Reagan tax cuts through the Senate, he wanted to end all state tax deductions but had to settle for ending it only for sales taxes. It was duly noted at the time that anything more would devastate state and

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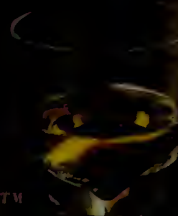
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his pistols won our battle
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Readers Report

CORRECTIONS & CLARIFICATIONS

"Brokers" (Footnotes, Sept. 6) may have left readers with the wrong impression of how much insurance they have in case their firms fail. Both full-service and discount brokers offer Securities Investor Protection Corp. coverage of up to \$500,000 per account. In our table, the column labeled "coverage" should have been labeled "excess coverage" to reflect private insurance for accounts larger than \$500,000.

"Fuzzy numbers" (Cover Story, Oct. 4) gave an incorrect first name for Capital One Financial Corp.'s CFO. He is Gary L. Perlin, not Greg.

"A new owner for Aspect?" (Inside Wall Street, Oct. 4) included an incorrect ticker symbol for Aspect Medical Systems. The correct symbol is ASPM (not ASMP).

In "One Hank Aaron shirt, please" (Personal Business, Sept. 27), Mitchell & Ness provided an incorrect price for its replica 1944 St. Louis Browns warmup jacket. It is \$575, not \$400.

local sales taxes. Actually, there was once a major country that combined a small income tax with a large consumption tax: It was the Soviet Union, which is hardly the sort of role model one expects from the GOP and its acolytes among economists.

—John E. Ullmann
Professor Emeritus
Hofstra University
Hempstead, N.Y.

A SEPARATE TAX FOR 'COST OF GOVERNMENT'

RE "AMERICA'S STARK FISCAL choice" (Editorials, Sept. 20, and "The national piggy bank is going hungry," Business Outlook, Sept. 20): My suggestion, short of a flat tax, is a universal "cost of government" (COG) tax of 1% that is assessed on income before any deductions or credits. Ten dollars per thousand (or six-tenths of a minute per working hour) of income is not a sacrifice, even at the minimum wage. That's enough to pay for the "war on terror" in total.

—Allen T. Hyde
Newland, N.C.

CALPERS' FUND RESULTS WERE BETTER THAN MIXED

IN "MEET THE friendly corporate raiders" (Finance, Sept. 20) on activist fund Relational Investors LLC, Chris

Palmeri says the California Public Employees' Retirement System (CalPERS) gave Relational its seed money but has had "mixed" results with investments in its other corporate governance funds. In fact, four out of the six corporate governance funds that CalPERS invests in beat their benchmark. Last fiscal year, the funds in total earned a 53% return for our beneficiaries. I would hardly call this mixed.

—Patricia K. Macht
CalPERS Office of Public Affairs
Sacramento

Editor's Note: *BusinessWeek* based its characterization on the data available to us at press time. It showed that three of the six funds did not beat their benchmarks since inception.

RESOLVING THE MERRILL MUDDLE

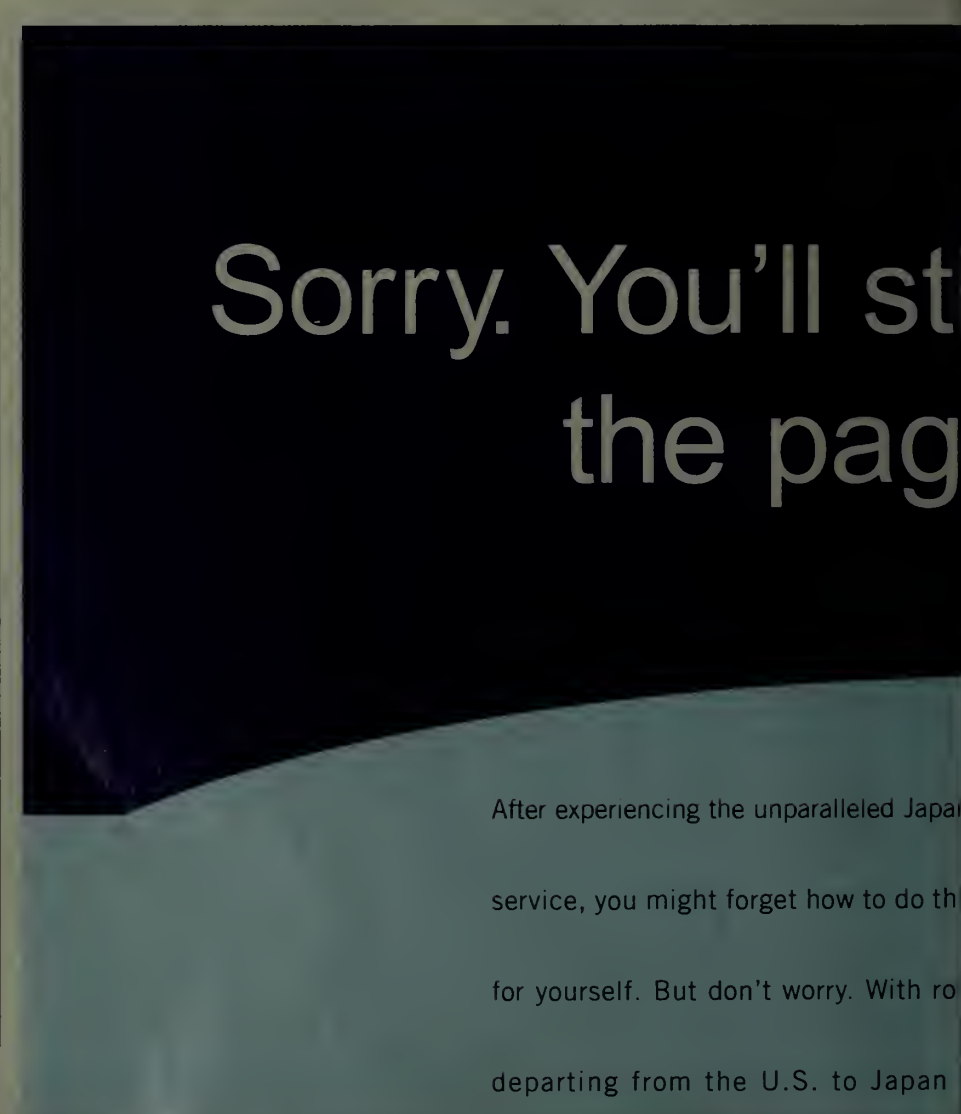
RE EMILY THORNTON'S article "Fed up—and fighting back" (Finance, Sept. 20) on women working to end discrimination on Wall Street: The 80-some Merrill Lynch women I interviewed were assured that I would hold everything they said in strictest confidence. They knew

their observations and recommendations would be submitted to the firm in a way that would not allow identification of any individual woman or the branch where she worked. Only when a woman explicitly gave permission, and it would shed light on the group's recommendations were the specifics of her experiences and views passed on to the firm. I am proud of the Merrill Lynch women who participated and of the work we did together during the year-and-a-half project.

—Patricia Ireland
Washington

WHEN I UNDERTOOK my case, I did so in part to test a process set up by Merrill Lynch, class counsel, and the lead plaintiffs in *Cremin et al v. Merrill Lynch*. There was a tremendous risk for me in going through a public trial, and it took an incredibly long time to get to trial. Many women are still in the process, and there are many women whose bravery allowed me to take my case to a level where it could be publicly documented.

—Hydie Sumner
San Antonio



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POSTPONING TREATMENT RAISES LONG-TERM COSTS

A PRESCRIPTION for health-care reform" (Economic Viewpoint, Sept. 20) missed a critical point: Glenn Hubbard indicates that a higher deductible and co-insurance will reduce utilization, resulting in a net spending decline of \$65 billion per year. If patients avoid seeing their physician until their condition has turned catastrophic, over the long term, the cost could dwarf the \$65 billion in savings achieved in the short run.

—Michael Flood
Larchmont, N.Y.

DIFFERENT SHARE CLASSES? THERE OUGHTA BE A LAW

LESSONS OF THE Hollinger chronicles" warns against the dangers of a CEO holding a controlling stake (News: Analysis & Commentary, Sept. 13). The "one man, one vote" rule seems to work well in politics. Let's have a "one stock, one vote" rule passed into law by Congress. Multiple tiers of stocks should be done away with. It should be illegal for insiders to arrange special deals that give themselves a

greater portion of voting power than they really deserve.

—Thomas Russell
New York

ATHENS GAMES: A VENUE SO NICE, LET'S USE IT TWICE

IT'S TIME FOR THE International Olympic Committee to consider awarding two consecutive Olympics to the same city ("A big fat Greek triumph," Sports Biz, Sept. 13). This will reduce the escalating risks of building infrastructure and providing security. Otherwise, smaller countries such as Greece will be priced out. A second pass for Greece would be an incredible boost for their economy and help retire their debt. And what's sacred about four years? How about a summer Olympics every three years?

—Steve Baker
Portland, Ore.

THIS ISN'T THE FIRST TIME CHEAP GAS HAS STALLED DETROIT

DAVID WELCH'S commentary "Detroit is over a (\$50) barrel" (The Corporation, Sept. 13) had that strange feeling of "déjà

vu all over again." Those of us who remember the oil shortages of the '70s remember that Detroit was not ready then either. The arguments were made that Detroit needed time to adapt to fight the invasion of European and Japanese cars, which were more fuel efficient. Now we find that in the past decade, Detroit has essentially given up on the car market, underinvested in fuel efficiency, and once again finds itself struggling against the Japanese and Europeans with their more fuel-efficient vehicles.

Cheap gasoline has been a curse disguised as a blessing for the U.S. automobile industry and the nation as a whole. Perhaps a gasoline tax that keeps prices high will reduce demand, spur innovation, and set the nation on a path toward more sustainable energy consumption levels.

—Kevin Quinn
New Providence, N.J.

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Inside Iraq

THE FALL OF BAGHDAD

By Jon Lee Anderson; Penguin Press; 389pp; \$24.95

On the eve of the Iraq War, Jon Lee Anderson received a phone call from his bosses at *The New Yorker* asking him to pull out of Baghdad as soon as possible. Luckily for readers, Anderson decided not to heed that advice, choosing to stay in the Iraqi capital throughout the “shock and awe” campaign and the mess that ensued.

In *The Fall of Baghdad*, Anderson melds his distinguished magazine dispatches into a broader work, offering superb reportage while resisting the temptation to moralize about either the Iraqis or the Americans. The account is a must-read for anyone trying to understand the anarchy that is now engulfing Iraq.

Anderson writes in the first person, but it is his ability to capture the voices of Iraqis whom he meets that makes this such an absorbing narrative. By describing events as they unfold through the eyes of a broad swath of Iraqi society—academics and apparatchiks, Baathists and barbers, poets and Muslim clerics—he weaves a rich tapestry of Iraqi life and survival first under Saddam Hussein’s tyrannical rule, then under American bombardment, and finally amid the postwar chaos.

One of the most memorable voices is that of Dr. Ala Bashir, a surgeon, artist, and confidante of Saddam. Bashir provides unique glimpses of another side of a man otherwise known only as a ruthless killer and megalomaniac. Deeply aware of his own lack of formal education, Saddam, we learn, is drawn to painters and poets and writers. His purges, which resulted in the deaths of many former comrades, says Bashir, left Saddam at times feeling conflicted.

Anderson’s own experiences of Baghdad life are also compelling. For example, he describes the surreal atmosphere of denial in the city before and during the war. Just nights before the conflict begins, he attends a grilled-shrimp dinner at the home of a senior Foreign Ministry official. His host cannot stay away from the TV, constantly flipping the remote so that he can simultaneously watch CNN and a broadcast of a Julia Roberts movie, *My Best Friend’s Wedding*.

Then comes the fighting. Anderson’s descriptions of the carnage inflicted on hundreds of innocent civilians are arresting and unforgettable.



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Outside an apartment complex flattened by a U.S. bomb, the author sees a man's hand, "the red and white guts of it, at the messily-severed stump, spilled out like electrical circuitry from a crudely-cut cable." Yet even as bombs are falling, Saddam's cult of personality still prevails. At a state hospital, several cleaning women jump up and down singing Saddam's praises as Anderson passes by them. Some days later, back at the hospital, he interviews a 12-year-old boy, his torso maimed, his arms burnt stumps. "His large eyes were hazel, flecked with green and he had long eyelashes and wavy brown hair." After telling Anderson he liked studying geography and playing volleyball and soccer, the boy remarks, unbidden: Bush is a criminal and he is fighting for oil."

But don't misunderstand: This is far from an antiwar polemic. Nuances are one of Anderson's strengths. In dealing with charges that U.S. troops may have been complacent about postwar looting, for example, the author simply offers unadorned anecdotes. We are witness to a U.S. soldier, manning a turreted machine gun, apparently oblivious to the attempt of several men to steal a nearby van still occupied by two dead bodies. Elsewhere, Anderson leads troops to a hospital being looted. When they arrive, rather than entering the hospital to defend it, the Marines leap out of their vehicles and take up combat positions to attack it, terrifying the doctors and nurses at the entrance.

As the author describes the deterioration of security in Baghdad, he reflects how, paradoxically, under Saddam's despotic rule, the city was an extremely pleasant place to visit, where one could prowl bazaars and coffee shops at will. But as the U.S. inability to control the country grows more and more apparent, there's an increasing frustration with and resentment toward foreigners. In Fallujah, for instance, a U.S. psychological-warfare officer, who is distributing handbills that announce the phase-out of dinar currency bearing Saddam's face, finds himself suddenly in an angry shouting match with a shopkeeper. "You should leave. Go away. I hate you," screams the man, whose grievances remain unclear. "I hate you too," the befuddled American finally replies. Not many hearts and minds were won over to the U.S. cause with that exchange.

Watching the invasion and its aftermath through Iraqi eyes

The book does, however, leave some questions unanswered. One would like to know, for example, how Iraqis reacted to the killing by U.S. forces of Saddam's sons Uday and Qusay. And more important, how did people feel after Saddam's capture last December? Also, Anderson does not appear to have

had any interviews with members of chief administrator L. Paul Bremer's coalition authority, or many Americans at all for that matter, apart from frustrated soldiers and two forgettable CIA agents.

The Fall of Baghdad, which covers the period up to the end of April, 2004, has proved to be disturbingly prescient. Even before the war, many people predicted the civil strife that has engulfed the country, saying that Iraqis would not welcome American soldiers now any more than they did the British, against whose colonial regime Iraqis rebelled in 1920. Tragically, it seems Washington's planners have learned little from history. ■

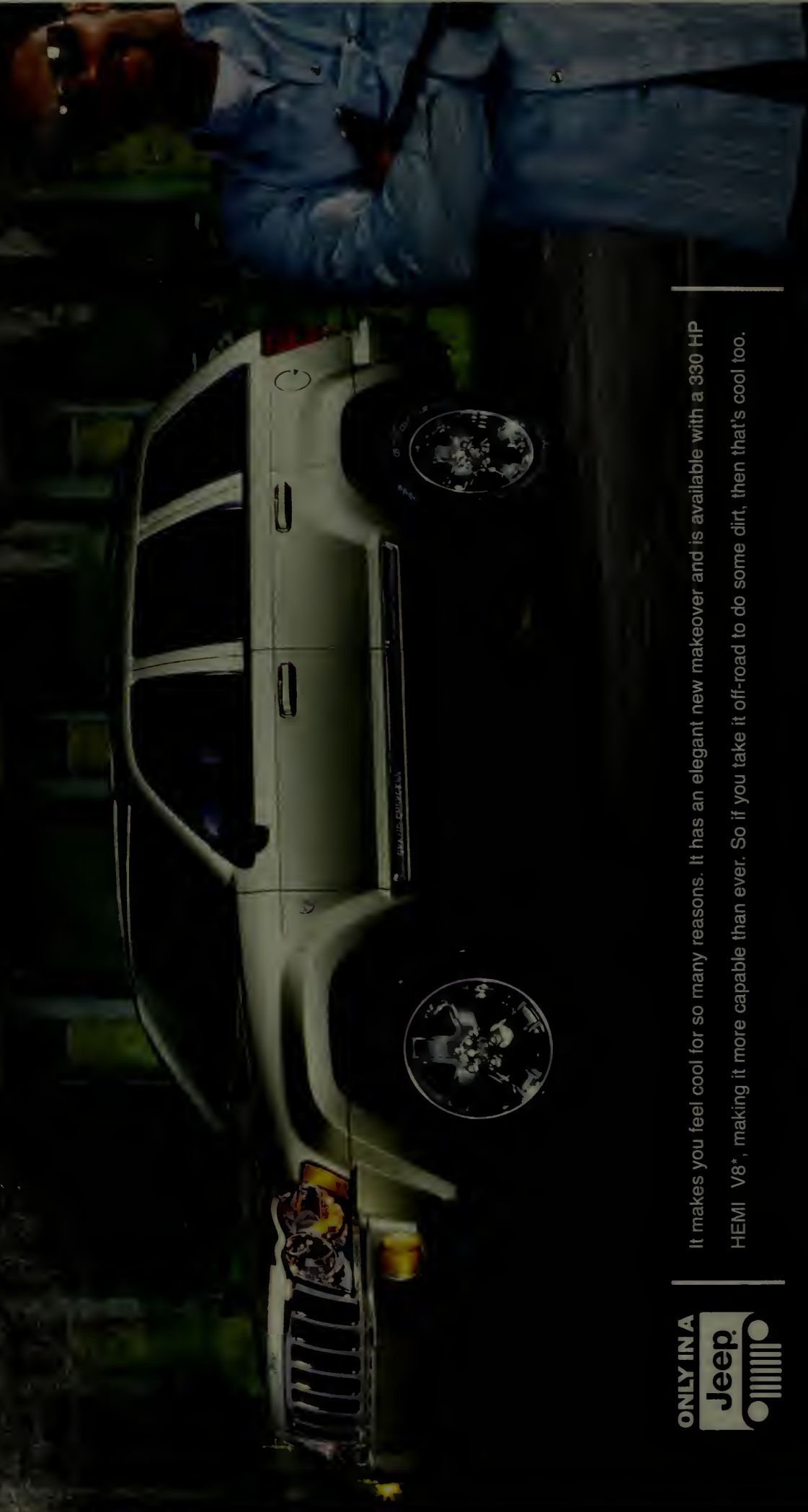
— By Frederik Balfour

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People Power: How Diversity Generates Results

Diversity leaders are seeing another side of "full employee engagement." Sure, the business case is still booming. Across industries, companies continue to see the improved innovation and new market outreach promised by diversity. But in this economy, diversity does more. Today, a strong diversity commitment signals the exceptional work environment—where each contribution is valued and all employees get every chance to succeed. Not only does that keep driving productivity. Not only does it bestow a significant recruitment edge. It also promotes achievement, encouraging people throughout the organization to reach for their best. What's more, it cultivates employee satisfaction—and when satis-



faction goes up, so does financial performance.

Your diversity model can set you apart—from everybody, for everybody. Beyond groups, beyond categories, today's diversity leaders can offer everyone in the organization a fair shake when it comes to career opportunity. That message breeds industry excellence. It motivates every kind of talent there is. It supports external relationships with vendors and customers that enhance competitive position. Now more than ever, it defines the kind of corporate America that has always been the engine of U.S. innovation, effectiveness and success.

The Inclusivity Formula: The Power of Parity

In the 1990s, diversity definitions expanded to include less-visible characteristics like parental status or religion. But today, the leaders say it's all about "inclusivity"—the drive and commitment to engage the unique qualities and abilities that every single employee can bring to the job.

Why do we need this? Increasingly, the term "minority" means nothing in America. The nation's population is diversifying so fast and furiously that by mid-century whites will comprise less than 50% of the U.S. population, according to the Census Bureau. That pace of complex change demands that corporate America leverage all relevant talents in each and every member of its workforce—no matter what his or her background.

That's what "inclusivity" is all about. It maintains core diversity values of equal opportunity, but shifts focus to look less at groups than at people, less at racial and ethnic backgrounds than at unique skill sets.

The biggest boon is that inclusivity breeds buy-in, even down through line operations where the message still too often gets lost. By engaging individual abilities, it enhances the sense of fairness and just rewards that diversity

was always meant to instill. It shows that diversity is something everyone can get behind.

That approach is changing the face of diversity—and its place in corporate hierarchies. Today, even so-called "majority males" are finding a place at the diversity table, and bringing their combined wisdom and experience with them. In the past, diversity has left many majority males "feeling they are seen only as part of a dominant group, not as individuals, valuable in their own right," explains Dr. Michael Kimmel, diversity expert and author of *Manhood in America* and *The Gendered Society*. That is, "they have felt the way diversity employees often feel: invisible as individuals and hyper-visible as a group."

Inclusivity "gets" that—and gets past it. It shows people that while diversity may appear to be about groups, it is actually about every person in the organization being treated as an individual. It's about being able to break out. The inclusivity formula, says Janet Smith, President of the diversity consultancy Ivy Planning Group, "can empower everybody in the organization to have the opportunities they deserve."

Not Just For Women Anymore: The Work/Life Advantage

The number one reason women change jobs is family obligations—not better opportunities, higher earning potential or old-job burnout, according to CareerWomen.com. Most Gen Y mothers say they will re-enter the workforce after having children, according to Silver Stork Research, but they will want changes, including flexible schedules and telecommuting. Half (51%) of executive women say they're looking for more work/life balance, according to Catalyst.

Sound familiar? It is. Work/life policies have long proven their potential to boost women's productivity, retention and effectiveness. But check

this: According to Catalyst, 43% of executive men now say they want better balance, too. In today's dual-wage-earner majority, work/life is not just for women anymore. It matters to almost everyone.

Yet the Society for Human Resource Management (SHRM) reports that for the first time in the last five years, many time-tested family-friendly policies have been downsized. This may be a very costly move. Some experts suggest it may push high-value talent out the door. A recent study by the Kauffman Foundation found African-American professionals, for example, are 50% more likely than others to

Diversity at Xerox A Source of Pride, Company-Wide

Xerox Corporation has long been recognized as a pioneer in fostering an inclusive corporate culture. And that's a source of pride, company-wide. Xerox ensures that diversity strategies are deployed not intermittently, within a particular division, but consistently and throughout the organization. No wonder premier diversity organizations including the Human Rights Campaign, Diversity Best Practices and the National Association for Female Executives (NAFE) have honored Xerox for its leadership.

The company walks its talk in every major diversity area there is. Its balanced workforce strategy, for example, expects managers to be proactive about diversity objectives—not only in staffing and recruitment, but also in retention, promotions, leadership development. To help employees balance diverse work/life demands, Xerox provides flex-scheduling and job-sharing, adoption and eldercare assistance, domestic partner benefits, help for first-time home buyers, and more.

The company takes its pride outside as well. Through a robust supplier diversity program, Xerox actively seeks out women- and minority-owned business partners, buying millions in goods and services each year from their firms. The company awards \$150,000 annually in scholarships to minority students pursuing scientific and technical degrees. The Xerox Foundation invests in historically black colleges and in INROADS, an organization preparing minority students for corporate and community leadership.

Xerox remains passionate about its distinguished tradition of valuing diversity everywhere it lives and works. The company understands diversity as an organizational engine driving competitive achievement in today's world.

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reject a 9-5 corporate career for the autonomy and opportunity of entrepreneurship. African-American women are more likely to start businesses than white women or Latinas, but it's Black men, especially young men 25-34, who are the most active in launching independent ventures.

They are part of a broader trend emerging about balance. No matter what their background, no matter what their industry or their expertise, younger workers repeatedly say work/life is pivotal to employee effort, performance and loyalty. Recently, the AFL-CIO found nearly 50% of women and 45% of men 18-34 assert their top job concern is having enough time for both work and family commitments. The issue is trending up: a more recent Radcliffe Institute study found more young men than women willing to trade traditional white-collar job values like prestige and even pay for better balance.

In any economy, turnover is usually more costly than benefits and getting high-value talent to stay reaps big returns. Now more than ever, work/life is the way to play—and play for keeps.

Diversity at Chrysler: "Our People Drive Our Business"

"Diversity is a source of strength for our company. It fuels our innovation. It connects us to our customers and to each other. And it defines our uniqueness. As such, it is a source of competitive advantage—a powerful blend of unique people and potential that no other company can claim," states Nancy Rae Senior Vice President of Human Resources for DaimlerChrysler. DaimlerChrysler's 40% women and minority representation is one of the highest in the industry.

As one of the top women at the Chrysler Group, Nancy leads the charge at the automaker by co-chairing, along with Tom LaSorda, DaimlerChrysler's Chief Operating Officer, the company's Diversity Council. The Council consists primarily of officers who meet monthly to discuss diversity-related strategies. Major areas of focus include workforce, minority suppliers, community and government affairs, dealers, sales and marketing and communications. "At DaimlerChrysler, we know that in order to remain competitive, we must continue to build upon our diversity to create inclusion and increase our ability to more effectively market to a diverse customer base."

One of our workforce initiatives is sponsoring Employee Resource Groups. These groups support employees of like backgrounds by providing networking, mentoring and educational programs specific to the needs of each group through direct communication with the Diversity Council. "Our people drive the business," states Rae. "Together we bring new, exciting products to the marketplace."

"To quote our Diversity Statement, 'Diversity makes good business sense,'" Rae concludes.

Your Value Proposition: Where Do You Stand?

A new study by the National Urban League asked more than 5,500 employees—men and women, of various racial and ethnic backgrounds, including executives, managers, salaried and hourly workers—about diversity effectiveness in their companies. The results are sobering: Only 32%—less than 1/3—felt their employer has effective diversity programs. Fewer than half of all surveyed were upbeat about company efforts on recruiting (49%), leadership commitment (41%) and career development (40%)—and these averages included executives, who were more salutary about initiatives and impact. But there is progress in top priority areas, and making challenges into opportunities is what American business is all about.

Making the Diversity Difference: Employee Views

Effectiveness of Top Practices	% Favorable	% Unfavorable
1. Inclusive culture and values	56	18
2. Retaining diverse talent	55	27
3. Marketing to diverse customers	50	15
4. Supplier diversity	45	17
5. Recruiting diverse talent	49	21
6. Advancing diverse talent	45	33

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Diversity Best Practices and Business Women's Network Diversity Leadership Summit and Gala Oct. 25-6, 2004, Washington, D.C.

<http://www.summit.bwni.com>

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June 7-9, 2005, Chicago
<http://www.conference-board.org>

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BY STEPHEN H. WILDSTROM

The iMac G5: Elegant—But a Lost Opportunity

No question about it, Apple Computer's new iMac G5 is beautiful. The minimalist design, whose echoes of the iPod are entirely intentional, would grace any desk. Although I have some quibbles with the details, the iMac offers outstanding performance at a fair price. Still, lovely as the iMac is, I think Apple may be blowing an opportunity to expand its market.

This is the third generation of iMacs, and the only family resemblance is an all-in-one design radically different from anything else on the market. The previous iMacs put their guts in a hemispherical base and used a clever arm that let you position the 15- or 17-inch displays just about anywhere you wanted. The new versions mount all the electronics behind the wide-screen 17- or 20-in. display that is only about two inches thick, and the entire unit stands on a curved aluminum foot.

Apple cools the system with large, slow-turning fans, so it's whisper-quiet. If you add the optional wireless networking card (\$79) and Bluetooth module and wireless mouse and keyboard package (\$99), the only wire running into your iMac will be the power cord. Mac OS X is the best personal-computer operating system today by a fair margin, and the iMac comes preloaded with Apple's very good suite of iLife programs, including iPhoto and iTunes for picture and music management, respectively, and the Garage Band music composition and recording system.

THE HARDWARE IS BEAUTIFUL, the software is beautiful—so what's wrong with this picture? For one thing, some functionality seems to have been lost in the interest of aesthetics. The previous generation of iMacs allowed almost unlimited adjustment of both horizontal and vertical screen angle and a considerable range of height. The new models offer effortless vertical tilt, but only up to 30 degrees. Horizontal movement is accomplished by swiveling the entire unit, which has a slippery plastic pad on the bottom of the aluminum foot. There is no height adjustment at all, a serious blow to good ergonomics. The iMac has a full complement of ports, including three USB and two FireWire sockets and even a digital audio link, but all the connectors, as well as the power button, are in the back. This keeps the front and sides perfectly clean, but it means you have to turn the unit to plug anything in.

Price is another concern. The cheapest iMac, the 17-in. with a 1.6 gigahertz G5 processor, doesn't sound too bad at \$1,299.



But Apple prices all of the iMacs with a bare minimum of 256 megabytes of memory, which will hobble performance. Bringing that to 512 MB adds \$75; moving to a gigabyte, which you'll want for Garage Band or any serious photo or video editing, adds \$225. Throw in the wireless options, and the base iMac is up to a hefty \$1,702, while the 20-in. version goes well over \$2,000. By contrast, you can get a Dell Dimension 4600 with a 3.2 GHz Pentium 4, a gigabyte of memory, and a 17-in. flat panel display for \$1,164. Elegance is expensive.

Considering the excellence of the software, Apple deserves a larger share of the market than the low single digits it has been able to garner, and consumers deserve more access to Apple products. The average selling price of a desktop PC is below \$750, and few go for more than \$1,000. But Apple's only sub-\$1,000 computers are two dated eMacs, bulbous all-in-ones with 17-in. CRT displays.

Apple could shake things up by rolling out a \$700 Mac

With any real improvement in Windows at least two years away, I think Apple could shake the industry by offering, for \$700 or less, a PC-like Mac box for which consumers would provide their own displays. The company wouldn't have to scrimp on features or quality; the unit would lack the elegant design of the iMac G5, but it would still be a Mac. Given Apple's obsession with beautiful but expensive industrial design, there is almost no chance we'll ever see such a product. And that's a shame, both for Apple and for its prospective customers. ■

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BY JEFFREY E. GARTEN

More Tough Questions For the Candidates

Last month in this column, I bemoaned the lack of election-year debate on critical long-term economic challenges. I posed three illustrative questions I would like to ask President Bush and Senator Kerry in an interview: How they would deal with the costly retirement of baby boomers; the competitive challenge of China and India; and catastrophic poverty in developing

countries ("Thorny Questions for the Next President," BW, Sept. 6). Judging from my mail, I sense keen interest in such fundamental issues. So here are three more questions I'd like to ask the candidates, plus the responses I'd hope to hear.

HOW WOULD YOU ADDRESS AMERICA'S GROWING DEBT TO THE REST OF THE WORLD? Our balance of trade and investment flows is deteriorating fast, heading toward an unprecedented 6% of gross domestic product. This is a 25% increase from last year. We now owe \$3 trillion abroad, up 100% since 2000, and we need to borrow more than \$1.5 billion per day from overseas lenders. Right now, in fact, foreign creditors are providing two-thirds of America's net domestic investment. If they lose confidence in the U.S. economy, they could quickly sell billions of dollars worth of Treasury bills and bonds, sending the dollar plummeting and sparking a global currency crisis. The Federal Reserve would then have to hike interest rates sharply to attract money from overseas. American mortgages, car loans, and credit-card bills would soar. The economy could go into recession.

At home, we have to reverse the reckless fiscal deficits that absorb our domestic saving and force us to borrow so heavily. We also must boost sales of U.S. products abroad by developing a workforce that can clearly dominate high-skill, high-wage global industries. That means more spending on research, more focus on education, and more effective worker-training programs. We must press Asian and European nations to deregulate their own economies to open them to more imports and stimulate GDP.

HOW CAN WE PROTECT OUR CRITICAL INFRASTRUCTURE FROM TERRORISM? The September 11 Commission underscored our general vulnerabilities, and the Bush Administration has admitted that key financial institutions are being targeted by al Qaeda. Whole sectors, such as the chemical industry, are dangerously exposed. The U.S. Coast Guard wants \$5.6 billion to minimally protect 95,000 miles of shoreline, but Washington has given less than one-tenth that. The federal government spends \$10 billion a year on missile defense but only a fraction of that on domestic counterterrorism.

The next Administration must rethink what assets we can protect and how we can limit the damage—and quickly

recover—from an attack. We shouldn't be increasing our defense budget by 50% while neglecting internal security, as we have done these past two years. Moreover, since the private sector owns more than 80% of America's production capacity, homeland security requires a level of government-business cooperation last seen during World War II. This collaboration should include CEOs, local governments, and first responders, and it must exist on federal and regional levels. We can no longer balance openness and security with the laws, institutions, and meager budgets that exist today.

WHAT SHOULD WE DO ABOUT NATION-BUILDING IN THE FUTURE? In both Afghanistan and Iraq, the U.S. was woefully unprepared for post-combat operations. America must get much better at helping failed or broken states such as Liberia, Haiti, or Yemen to achieve some stability. There are moral and economic reasons to help, but because these countries are global breeding grounds for insurgents, there is also a security rationale.

We must recruit and train specialists to help with the transition between the end of military hostilities and the establishment of civilian governments. Relying on combat soldiers for that, as we now do, doesn't work. A new nation-building corps will need skills to deliver emergency medical care, train police, and rebuild schools and roads. It must be flexible and able to move quickly, much as our domestic Federal Emergency Management Agency operates. It will need to work closely with our armed forces, with nongovernmental organizations such as CARE, and with the U.N.

With less than one month before Election Day, I doubt the candidates will give us their views on these issues. Shame on them, and shame on us, the American voters, for not having demanded that they do. ■

Jeffrey E. Garten is dean of the Yale School of Management (jeffrey.garten@yale.edu)

Our massive debt to the rest of the world could spark a recession

BY JAMES C. COOPER & KATHLEEN MADIGAN

Big Business Is a Big Spender Again

A broad-based capital-spending recovery is solidly under way

U.S. ECONOMY Capital spending is the lifeblood of future economic growth. Business investment in new equipment and buildings provides the means for expanding production, which generates growth in jobs, incomes, and demand. Longer-term, it also forms the base for gains in productivity and living standards. Given the solid

fundamental supports for capital spending, this economic recovery appears on its way to a healthy 2005.

Indeed, the capital-spending upturn is now entering a new phase. What began as a recovery fueled by the need to replace short-lived high-tech equipment, such as computers, has broadened into increased demand for longer-lived heavy machinery and other more traditional capital goods. Even outlays for business construction are showing signs of life after a steep, three-year plunge.

Clearly, high oil prices have raised some uncertainty about future demand. However, business outlays didn't miss a beat in either the spring or summer quarters, when oil rose into the \$40-to-\$50 per barrel range. In the second quarter, outlays for new equipment and buildings rose at a 12.5% annual rate, and based on recent monthly data on capital-goods shipments and construction spending, investment outlays in the third quarter should at least match last quarter's gain. Although consumer spending slowed in the second quarter, strong business investment helped the economy to grow a healthy 3.3%.

COMPANIES WILL CONTINUE TO INVEST for very basic reasons. For one, the pickup in demand last year caught businesses by surprise. Inventories are still exceptionally low relative to sales, and the massive elimination of capacity excesses that had built up in the late 1990s now appears to have generated some pent-up demand for capital equipment that has not yet been satisfied.

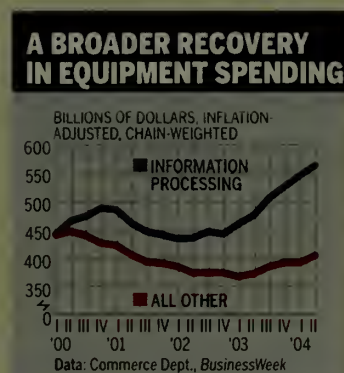
Also, financial conditions remain very accommodative. Profits and cash flow are growing more slowly, but the pace has fallen from spectacular to merely very good. And with corporate balance sheets in the best shape in years, low interest rates and friendlier banks are finally fueling a recovery in business borrowing, the newest indication that companies are looking to expand their operations.

The recovery in U.S. manufacturing is another key reason why the capital-spending upturn is broadening. Factories are spiffing up and beefing up their production capacity in response to better demand. To be sure, utilization rates, averaging 76% in August, are low, but operating rates have been rising since the second half of 2003. Historically, capital spending turns up as utilization rates start to rise.

In addition, businesses may have gone too far in redressing their capacity excesses. For almost three years, nonfinancial corporations allowed equipment to wear out at an unusually rapid pace, compared with the rate at which new gear was bought. Now, the ratio of new outlays to depreciation is rising as businesses recognize the need for more capacity. Even the growth rate of

manufacturing capacity, after falling from 8% per year in 1999 to 1% at the start of 2004, is slowly starting to accelerate.

Business outlays for equipment other than high-tech gear, which continued to fall for a year after tech outlays bottomed out, are now turning around (chart). Over the past year, spending for various



industrial and transportation equipment has picked up strongly, growing 8.6% from a year ago. That growth rate is faster than in any similar period of the investment boom of the late 1990s.

In the tech sector, outlays for communications equipment, which accounted for more than half of the recession cuts in tech spending, are making a comeback. Over the past year, inflation-adjusted telecom outlays have grown 22.7%. That's on a par with their 21.9% annual pace averaged during the telecom boom from late 1997 to late 2000. Clearly, operating at only 54.7% of capacity, the telecom industry still has a long way to go, but the capital-spending revival is helping.

MORE ENCOURAGING NEWS on capital spending comes from the construction industry. After the steepest contraction in business sector building in the postwar era, companies are slowly starting to build again. So far, the gains aren't much to get excited about, but they portend continued growth in the coming year.

In July, outlays for all types of private-sector business construction rose 5.9% from a year ago. That's far from

robust, but it was the best yearly showing since just before the recession began in early 2001. Outlays in the important commercial and office areas, more than 40% of the total, are now rising, albeit at a slow pace. The hot areas are hotels and lodging, health care, amusement and recreation, and power-generating utilities, all of which are growing at double-digit rates.

One sign that the upturn in business construction will be slow but steady is that vacancy rates have peaked, although they remain high. Another plus: So far this year, contracts for business construction, which tend to lead actual outlays, are running ahead of the average for all of last year, according to McGraw-Hill Construction Dodge. A rise for the year would be the first since 2000 (chart).

PERHAPS THE MOST FAVORABLE PART of the capital-spending outlook is the extremely accommodative financial conditions that companies now enjoy. For most of the past year, they have been able to finance all of their outlays for new capital equipment, buildings, and inventories out of their current gusher of cash, something that has rarely been possible in the postwar era.

Cash flow has received a special boost from the "bonus depreciation" provisions of last year's tax package. Although the provisions are set to expire at yearend, the Federal Reserve Bank of Philadelphia reported that the companies it surveyed generally do not plan to cut back their capital spending as a result of the expiration.

With internally generated funds plentiful, companies have avoided heavy borrowing, reduced debt, and

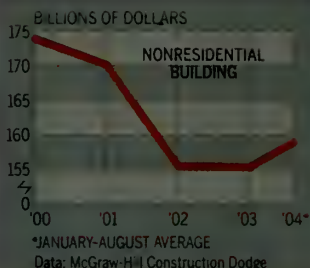
repaired balance sheets, even while they were boosting their capital spending. Over the past year, assets of nonfinancial corporations have grown more than twice as fast as liabilities, and their ratio of credit-market debt to net worth has fallen to the lowest level since 1989.

Profit growth is now slowing, a trend that is typical at this point in the recovery, as costs pick up and productivity slows. So companies can now turn to the credit markets and banks to finance their operations, and interest rates are very low. Already, businesses show new signs that they are borrowing more. Commercial and industrial loans from banks have turned up in

recent months, after a three-year decline. And the Federal Reserve reports that banks are actually easing their lending standards this year after more than five years of tightening them.

Despite all these supports, business decisions on capital spending will boil down to one thing: Confidence in future demand. Oil at \$50 per barrel for the rest of the year might well generate a new round of corporate caution. Still, history shows that once a capital-spending recovery gains momentum, it takes a lot to slow it down. ■

BUSINESS CONSTRUCTION CONTRACTS TURN UP



EUROPEAN UNION

Sending the Wrong Signal to Business

THE EUROPEAN UNION is taking another step in regulating its labor market. Plans to increase monitoring of worktime and cap weekly working hours were approved by the European Commission. The proposal will now be sent to the European Council and Parliament. If passed, the measures intended to protect workers' health and safety could also be a competitive drag for the EU.

Some members will maintain exemptions for specific industries, such as health care and tourism. And the initial impact of the proposed changes to the Working Time Directive could be limited, given that most workers in Germany and France,

the euro zone's largest economies, already have 35-hour workweeks.

The bigger issue is the message the proposed rules send to businesses, especially after some companies recently negotiated longer workweeks with unions. Less labor market flexibility and more regulation could make the EU less attractive to foreign

investment, says Neil Bentley, head of skills and employment at the Confederation of British Industry. The risk is amplified as cheaper, less regulated sources of labor in China and India become more accessible for outsourcing.

Britain and the 10 new EU members are likely to resist. Britain currently has the most

liberal opt-out policies. Any worker can sign a waiver to work more than 48 hours per week. The new policies could have a particularly big impact on Britain's financial sector, where people put in long weeks and monitoring is sporadic.

New EU members may also be disproportionately affected. In places like Poland and the Baltic states, there is less capital investment and labor is cheaper. Longer workweeks help these countries compete.

In a separate report, the EU recently warned that the union is falling short of a goal to increase the labor participation rate from 63% to 70% by 2010. Brussels noted employment growth was 0.2% in 2003 compared to 0.9% in the U.S. and said the EU must "increase its adaptability" in order to reach its target. The latest move appears to be a step in the wrong direction. ■

—By James Mehrling in New York

TIGHTER WORK RULES

Proposed Work-Time Reforms:

- Employers must keep records of employees' work times and submit the data to national agencies
- Opt-out exemptions must be approved by unions
- Hard cap of a 65-hour workweek
- Opt-out consent may not be given at the same time as employment contract signing
- Reference period to calculate the average workweek is raised from four months to one year

Data: European Commission



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MORTGAGES

FANNIE MAE: WHAT'S THE DAMAGE?

It may not be that bad. The housing titan could emerge bloodied but intact as it fights charges of financial wrongs

FOR YEARS, FANNIE MAE has stood like a colossus astride global financial markets. With \$1 trillion in assets, it owns or guarantees more than one-quarter of all residential mortgages in America. Its debt, long considered rock solid, is held as reserves by foreign central banks, as capital by thousands of commercial banks. Its stock, and the pools of mortgages it packages and sells, are held by legions of mutual and pension funds. It inspires envy among banks that would like a piece of its lucrative business and have campaigned for years to strip it of its special status as a government-chartered financier.

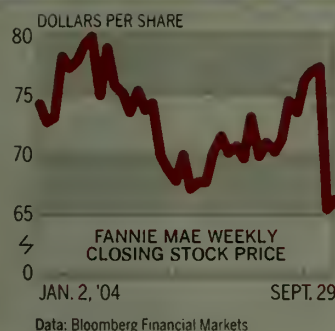
Today, though, the colossus is hobbled. A searing, 211-page report of a Special Examination of Fannie Mae released on

Sept. 22 by the Office of Federal Housing Enterprise Oversight paints an ugly picture of a company tottering under the weight of the sort of baleful misdeeds that marked the corporate scandals of the past three years: dishonest accounting, lax internal controls, insufficient capital, and me-first managers who only care that earnings are high enough to get fat bonuses and stock options. The once-obscure regulatory agency lays out in mind-numbing detail dozens of Fannie's alleged accounting errors and management mistakes.

Worse, it hints that Fannie's earnings as far back as 1998 may have been much lower than those in its financial statements. If OFHEO is right, Fannie may be undercapitalized and, disturbingly, not as financially solid as it appears.

Fannie's initial reaction did little to assuage such worries. Within five days—possibly the quickest resolution of a major corporate crisis in modern times—directors waved the white flag and agreed to a sweeping settlement on OFHEO's draconian terms. The pact requires Fannie to

KNOCK DOWN



boost capital by 30%, improve its accounting, and impose stronger internal controls. Fannie must get OFHEO's approval for a wide array of policy decisions, including any dividend increases or accounting chain-of-command changes. The board also named former New Hampshire GOP Senator Warren Rudman to oversee an investigation into whether Fannie's officers deliberately made end runs around accounting rules or committed other malfeasance.

With its board on the run and Chief Executive Officer Franklin D. Raines's job on the line, Fannie looks to be in a tight spot. But before a legion of critics—rivals, short-sellers, Republican lawmakers, and economists—celebrate the end of its dominance in the mortgage-finance market, they might consider the powerful defense it could mount.

Fannie's defense against OFHEO's charges could be formidable. A spokeswoman said neither Raines nor anyone else at the company would comment. But in interviews with former employees, securities and legal experts, accountants familiar with Fannie's books, other financial regulators, and outside advisers to Fannie, a picture emerges that differs from the one OFHEO has painted: Raines & Co. could argue that Fannie itself brought many of the issues cited in the report to the attention of OFHEO. Fannie's management even vetted the complaints of a whistle-blower to the board's audit committee, and then told OFHEO as well. And Fannie's outside auditor, KPMG, certified its results knowing OFHEO's concerns.

More important, the Securities & Exchange Commission will have the final word over whether Fannie must restate past earnings—and the SEC may disagree with OFHEO's two most damaging allegations, over accounting for derivatives and delayed recognition of expenses. If so, the SEC could blunt, if not wipe out, the financial impact of the alleged misdeeds.

Even so, the SEC may well concur on one serious charge: that Fannie violated

generally accepted accounting principles (GAAP) when it deferred \$200 million in expenses in 1998. OFHEO says that the move helped Fannie hit an earnings target that triggered \$27 million in bonuses for top execs. But even here, the SEC could undermine OFHEO by concluding that the incident occurred too long ago for the SEC to demand a restatement. The commission could bring enforcement actions if it concludes Fannie purposefully deferred expenses to trigger the bonuses, or created "cookie jar" reserves to meet other earnings targets—another of OFHEO's

allegations. But accounting and legal experts who have read the report say it contains no evidence of illicit intent, nor does it give other examples beyond 1998 where execs were rewarded as a result of managing earnings.

Deciding whether OFHEO's accounting charges are valid could come down to a war between accountants over the nuances of two key accounting standards, one of them 800 pages long. "My sense is OFHEO has gone overboard," says Edwin Walczak, who manages the Vontobel U.S. Value

Fund, a long-time holder of Fannie stock.

Even if the SEC takes Fannie's side, the lender will come out of this donnybrook bloodied. Much of what OFHEO has uncovered is disturbing. OFHEO alleges that the smoothing of swings in earnings "was a central organizing principle" in its accounting policies. Chief Financial Officer J. Timothy Howard has "inordinate responsibilities," OFHEO says, as chief risk officer, controller, and overseer of Fannie's vast investment portfolio. He also sets the salary of Fannie's chief internal auditor, which undermines his independence. Howard would not comment. Fannie's board has pledged to review Howard's duties.

FORGIVING MARKET

NOT SURPRISINGLY, THE OFHEO report tripped alarm bells around the globe. If worries about Fannie's soundness had gathered momentum, they could have cost Fannie dearly by pushing up its borrowing costs. Credit-rating agencies placed Fannie's subordinated debt and its preferred stock on credit-watch, but kept a triple-A rating on most of Fannie's other debt.

Faced with a major crisis, Fannie's board teleconferenced over the Sept. 25-26 weekend and agreed to settle. That helped keep the bond market calm. But equity investors have taken a hit—Fannie's stock closed at \$66.25 on Sept. 29, down 12.4% since the day before the report's release. Equity investors, accustomed to Fannie's stellar growth, fear the reforms agreed to with OFHEO could cut its earnings growth. Despite all the bad news, says Bernie Schaeffer, chairman and CEO of Schaeffer's Investment Research Inc.: "The market has been forgiving."

Indeed, Fannie may be able to weather the turbulence with relative ease. It began conserving capital during OFHEO's eight-month exam. Already it has an 18%



CFO HOWARD His duties are under board review

The Case Against Fannie

Fannie Mae's regulator, the Office of Federal Housing Enterprise Oversight (OFHEO), uses hard-hitting language and draws dire conclusions in its 211-page report. But the ultimate impact of its findings is far from clear:

TIMING EXPENSES

When Fannie pays a premium to buy a mortgage, it is supposed to amortize the extra payment over the mortgage's expected life—a tricky task because it has to predict future interest rates and guess when homeowners will refinance. OFHEO alleges that, since 1998, Fannie has improperly used such adjustments to smooth out its earnings, although it didn't say by how much.

POSSIBLE FALLOUT Fannie may have to adjust more than three years of earnings. But the changes could net out to close to zero. If so, it won't have to add capital to make good a shortfall. The SEC has the final say on whether Fannie needs to restate earnings.

HEDGING ITS BETS

Since 2001, Fannie has kept the running gain losses on its \$1 trillion portfolio of options and other derivatives off its earnings statement by treating them as hedges. OFHEO alleges that Fannie didn't qualify for this break because it didn't test whether the derivatives were eligible for such treatment. Now, OFHEO says Fannie not use this method at all.

POSSIBLE FALLOUT Fannie could suffer a billion hit from losses on derivatives, offset by a billion of gains, if OFHEO prevails. But the impact could be greatly diminished if the SEC rules that Fannie can continue to account for derivative losses this way if it follows the rules more closely.



FALCON The oversight chief goes before Congress next

stalled this year, despite an accounting scandal at smaller rival Freddie Mac in 2003, because Congress feared upset-

ting the housing sector in an election year. "But now you're talking about the big boy," says Hagel. "If that doesn't shake some [lawmakers], they've been living between Pluto and Saturn."

The political momentum was intentionally generated by OFHEO. The regulator's strategy: take its report first to Fannie's board on Sept. 20, and not give management a chance to see—let alone rebut—its findings. That's a far cry from the give-and-take that most regulators' exams entail. A former bank regulator, who considers OFHEO Director Armando Falcon Jr. a friend, faults him for making the report public before giving Fannie a chance to respond: "If you're really worried about safety and soundness and contagion effects in the market, most prudential supervisors would have dealt with this in private and slowed down the report's release." Through a Fannie spokesman, a director says the board didn't object when OFHEO asked to release the report.

"SIN NO MORE"

THE SEC PLANS to handle its probe of the OFHEO allegations differently. One SEC official says the agency will give Fannie a chance to make its best case. And it could differ with what may be OFHEO's most damaging charge—that Fannie's hedge accounting is improper. Fannie uses nearly \$1 trillion in options and other derivatives to offset interest-rate and prepayment risk in the pools of mortgages it finances. Standard accounting would require it to record gains or losses in their value in earnings each quarter—making reported profits volatile. Fannie instead uses hedge accounting to keep the swings in asset value out of its earnings.

But to do so, Fannie must routinely test whether the derivatives are properly matched to the assets they're hedging. OFHEO alleges that Fannie failed to do those tests. "Their approach is so complicated and so large that they lost track," says James Midanek, an investment manager at Walnut Creek (Calif.)-based Midanek/Pak Advisors. OFHEO says that Fannie misapplied the rules since 2001—and wants the SEC to order it to stop using hedge accounting. As a result, some \$7 billion in net losses in the derivatives portfolio must be subtracted from income. That's quite a hit: Fannie's net income was \$7.9 billion last year. But the SEC could give Fannie a chance to adopt

surplus over the minimum capital required by regulators. That means it needs only about \$5 billion more to reach the 10% cushion OFHEO now requires—and has nine months to get there. Fannie has many options: It could reduce borrowings, cut or trim its dividend, sell preferred stock, postpone plans to repurchase shares, shed assets, or do some

combination. Says Marshall B. Front, whose Front Barnett Associates LLC manages \$1.4 billion, including \$33 million of Fannie stock: "It appears that Fannie Mae is going to be able to accomplish the higher capital without any more than a negligible economic impact."

Fannie, infamous for its muscular lobbying presence in Washington, may not escape so lightly on Capitol Hill. Nebraska GOP

Senator Chuck Hagel, who sought to transfer Fannie's regulation to the Treasury Dept. from the Housing & Urban Development Dept., says he plans to push his legislation forward next year. Longtime Fannie critic Representative Richard H. Baker (R-La.), is expected to match Hagel's moves in the financial services subcommittee he chairs. Their efforts

DAMAGING EARNINGS FOR BONUSES

It says Fannie "in at least one instance" in 1998 deferred expenses so it could hit earnings targets and trigger millions in executive bonuses.

POTENTIAL FALLOUT Could be damaging. The \$200 million deferred expense was not enough to meet profit goals and release \$27 million in bonuses. OFHEO did not prove bad intent and cited no other examples.

FORGING A WHISTLE-BLOWER

It says Fannie failed to investigate adequately 2003 allegations by Roger Barnes, a former accounting employee, that the computer systems Fannie used to calculate amortization were wrong.

POTENTIAL FALLOUT Perhaps none. The report buries the fact that it brought Barnes's claims to OFHEO. Fannie's in-house audit team, the auditor, chief financial officer, and board were all informed and decided that Barnes was incorrect.

procedures to make sure its hedging is done properly. "We could say 'go and sin no more,'" says the SEC official.

The second most serious charge is that Fannie delayed recognizing certain expenses—largely prepaid interest—if they were below a threshold. OFHEO says that is inconsistent with GAAP. But the SEC may beg to differ: Other companies often make similar judgments based on whether a dollar amount is material. The SEC could wave off the charge, unless Fannie intended to manage earnings or create a cookie jar reserve. "It gets into a

whole lot of judgment between the auditor and the [company]," says one SEC official. "You wouldn't necessarily do your accounting down to the last dollar."

Fannie's intentions will surely be the focus of the SEC's review of the \$27 million in 1998 bonuses. If OFHEO, whose examination continues, uncovers more cases where earnings management helped execs hit performance goals in order to get bonuses and stock options, the SEC may bring an enforcement case.

Washington is abuzz over Falcon's chutzpah and the merits of his case. Says

Stanley Sporkin, a retired federal judge and ex-SEC enforcement director now advising OFHEO: "More than any other case I've seen, it's all there." But OFHEO isn't taking any chances. After all, it hired Sporkin for his deep connections within the SEC. And on Sept. 29, he and Falcon met with SEC Enforcement Director Stephen M. Cutler. With the forces massing on both sides, it could be a long and bitter battle. ■

—By Paula Dwyer and Amy Borrus in Washington, with Mara DerHovanesian in New York and bureau report

MORTGAGES

Why Low-Income Lending Won't Take a Hit

Will low-income families become innocent victims of the crackdown on Fannie Mae? After all, one of Fannie's official missions is to increase the rate of homeownership by expanding the pool of capital available for mortgage loans. If Fannie shrinks that pool, low-income people could find it harder to get mortgages and buy homes.

But most experts say the risk of that is small. They think Fannie may not have to shrink its business at all. And even if it does, others will likely step in to fill the breach. Fannie's fixes to its accounting problems—especially strengthening its capital position—"will have no impact on minority and low-income homeownership," argues Karen Shaw Petrou of Federal Financial Analytics Inc., a firm that keeps track of Fannie and Freddie Mac for banks and other clients.

To resolve its accounting disputes and bolster its financial health, Fannie has agreed to boost the ratio of its capital to its portfolio of mortgages and mortgage-backed securities. One way to do that would be for it to buy and hold fewer mortgages, which might make lenders less willing to lend and nudge interest rates up slightly. But Fannie may not need to do that. Instead, it could sell preferred stock or retain more of its earnings, improving the



HOMEOWNER COLEMAN Fannie helped her buy

capital-to-assets ratio without reducing the size of its portfolio. Even those who think there might be an impact on low-income buyers say there's no reason to believe it

would be large. Says Alan S. Blinder, a Princeton University economist: "Some curtailment [of mortgage purchases] is certainly a reasonable expectation, but there's no way to know about the magnitudes."

Even if its agreement with the Office of Federal Housing Enterprise Oversight, its regulator, puts a squeeze on

Fannie, minority lending would be the last place it would cut back. For one thing, Fannie's special status, in which its debt is implicitly guaranteed by the U.S. Treasury,

was granted in part because Fannie is expected to encourage low-income lending. Under pressure from critics who say it hasn't been doing enough, Chief Executive Officer Franklin D. Raines recently vowed to help create 6 million more new homeowners, including 1.8 million new minority homeowners, and to drive up minority homeownership from half to 55% by 2014. So

there should be plenty more happy new home buyers like Cassandra Coleman. She was able to buy a house in Milwaukee last year in part because the bank that originated her mortgage partnered with Fannie Mae to help first-time home buyers.

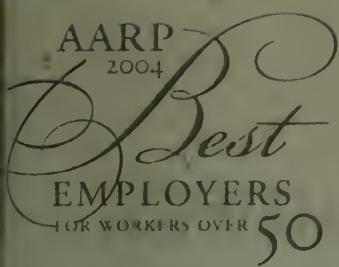
If, against all odds, Fannie did pull back on its support for minority home buyers, the private markets probably would fill in the gap. Under legal prodding, banks and other lenders have increased their lending to low-income buyers—and have found that

the business they once avoided is lucrative. "I think there's an awareness that this can be a good business," says Marc H. Morial, chief executive officer of the National Urban League.

And there are other institutions that can buy up mortgages in the secondary market. Freddie Mac, Fannie's sibling in mortgage financing, would be eager to increase its role in that arena. So would the 12 regional Federal Home Loan Banks, which hold mortgages jointly with banks in their system, assuming interest-rate risk. "This gives the home-loan banks an opportunity," says Alex J. Pollock, former head of the Federal Home Loan Bank of Chicago. Add it all up, and there's little reason to think that Fannie Mae's woes will spill over to low-income home buyers.

—By Joseph Weber in Chicago

If Fannie pulled back, private lenders would step in



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COMMENTARIES

Oil Prices Won't Spook Consumers...

Confidence has slipped, but household finances are in pretty good shape

BY KATHLEEN MADIGAN

HERE WE GO AGAIN. Every time oil prices rise a lot, fears about consumers shoot up like gushers. If families have to shell out more for gasoline and heating oil, they won't have money to buy other items, the argument goes. And a fall in consumer spending, moreover, pushes the economy into a sharp slowdown.

But hold on a minute. Yes, sticker shock at the pump hurts, especially for moderate- and low-income families who spend a larger share of their budgets on gasoline. And now that natural gas prices are following oil's upward climb, heating bills could be painful this winter, especially if frigid weather comes early.

Still, consumers have a lot going for them, and these positives should outweigh the drag coming from high energy costs. Jobs and incomes are growing at solid, albeit not spectac-

ular, rates; wealth is at a record high; and interest rates, including mortgage rates, remain near all-time lows.

What's more, even with oil and gas prices soaring, energy takes a smaller bite out of household budgets than it used to thanks to better home insulation and cars that are more fuel-

efficient. During the oil shock of 1979-80, 6% of the average household budget was spent on energy goods from gasoline to heating oil. Now the share is less than 3%.

But didn't high gas prices cause the slowdown in the second quarter, when growth and consumer spending slowed dramatically? Only in part. True, high energy costs left less money to spend on other items. But an equally important reason for the spring slowdown was a drop in vehicle sales after auto makers removed many incentives. Now the deals are back and so are car sales. Household spending

WEALTH IS RISING



...Wrong. You Can't Ignore \$50 a Barrel

High fuel costs look here to stay—and they may well dampen the economy

BY BRUCE NUSSBAUM

THE PRICE OF OIL IS UP, and consumer confidence is down. But most economists don't seem terribly bothered by the impact of \$50-a-barrel oil on the economy. They argue that consumer price index inflation remains low, and consumer spending is still strong. But economists shouldn't be so sanguine. Remember that consumer spending accounts for 70% of the economy. In the first quarter of the year, it grew at a 4.1% annual rate. But when oil prices took off last spring and people faced sticker shock at the pump as gas prices topped \$2 a gallon, they cut back on other discretionary spending. In the second quarter "soft patch," consumer spending grew at only a 1.6% rate, a dramatic fall from earlier in the year and pretty close to when the U.S. was in recession.

It's time to recognize that higher oil prices

act as a heavy tax on consumers. That money, which flows to the Middle East and other countries, could be spent in the U.S. to generate growth, profits, jobs, and tax revenue.

It's also time to admit that America needs a serious conservation program to cut its energy use. It's true that the U.S. is much more energy-efficient today than in the 1970s, so higher oil prices have less overall impact on growth. And yes, real oil prices are still below their peak as well.

But let's not exaggerate our good fortune. Real oil prices are already back to the level of their last peak in 1990. Demand from China, political uncertainties in Nigeria, Russia, and the Middle East, and underinvestment in exploration all mean that oil prices will probably remain high for years. Futures contracts out to five months are \$47 per barrel. For the previous 15 years, with only a few exceptions,

OIL HAS SOARED



on track to grow by at least 5% in the third quarter. In other words, consumers still managed to shop at a robust clip, even when gas averaged \$1.85 a gallon for the quarter. The economy probably grew at close to 4% in the third quarter, after a 3.3% advance in the second.

Look to employment growth to explain the rebound. So far in 2004, hiring has averaged 30,000 per month. That's not angbusters, but it has been good enough to raise labor compensation by 4½% in the past year. And the gains in salaries come at a time when other sources of income are increasing rapidly. Both dividends and the income of owner-operated businesses have increased by almost 5% during the past year.

Besides income, consumers have two other supports to depend on. First, according to Federal Reserve data, household wealth rose to a record \$46 trillion in the second quarter. Granted, the distribution of financial assets in the U.S. is highly tilted toward the already wealthy. But some inroads have been made. Today, a majority of households owns stock, and a record 68% own their own homes, so more households are benefiting from rising home and stock values.

Second, consumers can still borrow. Although the Fed is hiki-



THE TOUGH GO SHOPPING Income growth is up, and so are real estate values

When the Labor Dept. reports on September payrolls on Oct. 8, the data could be skewed by Hurricanes Frances and Ivan. Nevertheless, economists expect the gain to be 175,000, on par with this year's average.

Barring a collapse in the job market, consumers will prove their mettle. They've done it many times before. Just look at what happened after the terrorist attacks of 2001. Economists worried that consumers would avoid public places like stores and that their retrenchment would trigger a deep recession. Instead, auto makers slapped on 0% financing, and bargain-hunters came out to shop. Consumer spending in the fourth quarter grew at a 7% annual rate, the most in 15 years. The lesson: No matter what the adversity, never count out the American consumer. ■

five-month forward contracts traded in a narrow range around \$20 per barrel. Crude-oil futures for next September are trading at close to \$44.

A year ago economists were predicting that oil prices would fall sharply, down into the \$30 range. Now the markets are saying \$40 to \$50. So tight and fragile are those markets that a small revolt here, a hurricane there, and we could see oil staying in the \$50 neighborhood for quite some time.

Consumers are beginning to take note. Many are facing both rising gasoline prices and higher home heating costs at once. Home heating-oil prices are already up 25% from last year in the Northeast, and many homeowners are holding back, hoping prices will drop. If they don't, the economy may well hit another soft patch.

Not everybody, of course, will get hit equally hard. With personal wealth at all-time highs, higher stock dividends flowing, and house prices still rising in parts of the country, the top third or so of all families won't be crimped in their spending habits very much. In fact, many are reacting to this past sum-



WINTER WOES Home heating-oil prices are way up from last year

sought-after Prius. Japanese makers are so far ahead, they are on the verge of making hybrid engines optional for nearly all their cars.

But no move on the part of the auto makers will save consumers from the pain of high energy costs in coming months. One of the few economists of stature to continually warn of the danger of higher oil prices is Federal Reserve Chairman Alan Greenspan. He, of course, speaks from experience. Greenspan has in previous decades had to deal with recessions and slowdowns that resulted from rising oil prices. He doesn't want to do it again. Neither should we. ■

ing short-term interest rates, the bond market has pushed long-term yields down. Mortgage refinancings have increased for four weeks in a row. And thanks to past refs, consumers are not drowning in IOUs. The Fed reports that debt servicing in the second quarter took up 13.1% of income, essentially unchanged from last year's 13.2%.

The biggest danger for consumers from high energy prices is that they will cause businesses to cut back on their other expenses, namely labor. If hiring turns south, then it will be time to worry about consumers. That doesn't look to be the case now.

mer's shocking prices at the gas pump by switching from truck-based sport-utility vehicles to new, smaller car-based SUVs, which get better mileage. Moreover, demand for high-mileage hybrid cars is soaring. There is a long waiting list for the new Ford Escape hybrid SUV.

So yes, the markets are working their wonders, with higher oil prices finally pushing people to think about conservation. Detroit could do a lot more to help. It is two to three generations of hybrids behind the Japanese and still hasn't a single model to match Toyota's

ENERGY

A GUSHER OF CASH FOR DOMESTIC DRILLING

With prices high, private-equity outfits are playing the energy game to the hilt

WHILE THE REST of the country frets over surging energy prices, a small but growing group of businesses is fueling a boom of sorts in the U.S. oil patch. Dozens of new exploration and production companies, backed by billions of dollars in private equity, are forming to take advantage of flush times. While such players have sprung up in past cycles, "it will be much more pronounced" this time around because investors are confident that oil and gas prices will remain high, predicts energy analyst John E. Olson of Sanders Morris Harris Group Inc., a Houston-based brokerage.

The new money is increasingly focused on drilling for new pockets of natural gas and oil, not simply acquiring and exploiting mature properties left behind by the majors and the large independents, which are chasing bigger opportunities overseas. "The United States oil-and-gas story isn't one about BP Amoco, Exxon, or Chevron anymore," says Kenneth A. Hersh, managing partner at Natural Gas Partners, a big private-equity firm in Irving, Tex. "There are many private companies who are doing exciting things, who are making things happen."

These explora-

tion-and-production upstarts—mostly run by energy-industry veterans—will brighten an otherwise dismal picture for domestic production of oil and natural gas. The Energy Dept. this year predicted that onshore oil production in the Lower 48 states would fall 1.8% a year through 2025, while natural-gas production in the same area would rise 0.7% a year over the same period. A burst of fresh investment should improve both figures, at least incrementally.

SAVIER STARTUPS

THAT SAID, THE EXTRA output won't be enough to yank energy prices back to earth. In fact, barring a big slump in demand, "we're hard-pressed to see anything...that will bring down prices a lot," says Arthur L. Smith, CEO of energy consultancy John S. Herold Inc.

That's just fine with investors. Gary R. Petersen, a principal at EnCap Investments LP, figures private-equity firms such as his with money from insurance companies, universities, and other insti-

tutional investors have at least \$5 billion earmarked for North American exploration and production companies, double the level of three years ago. More broadly, Cameron O. Smith, senior managing director of Cosco Capital Management LLC, estimates at least \$15 billion to \$20 billion in private capital is available for investments in North American energy companies of all sorts—from E&P to coal to services—about double the amount of a decade ago.

That's not even counting those who are starting up by tapping friends and family. Joseph W. Foran recently launched his second energy company, Matador Resources Co., with \$50 million from wealthy friends and neighbors. He started his last one 11 years ago with \$270,000 and sold it last summer for \$388 million.

The new crop of startups is savvier than those of the past, some observers contend. They're typically run by executives age 35 to 60 who have already managed through booms and busts, says Herold's Smith, who counts at least two dozen private E&P companies formed in the past several years. "The people getting the capital are much more disciplined," agrees Randy A. Foutch, founder and CEO of Latigo Petroleum Inc. in Tulsa. He started Latigo, his third energy venture, two years ago with \$300 million in equity from Warburg Pincus LLC and JPMorgan Partners.

Another difference: In the case of natural gas, the drilling is often in unconventional reservoirs that were previously ignored, such as tightly packed sands and coal seams containing gas in the Rocky Mountains, Texas, Oklahoma, and other areas. The risk is fairly low because geologists know gas is there, even if it's hard to extract. And investors aren't spending much on high-stakes exploration in unknown territory.

The influx of money has helped to boost the number of wildcat exploration wells drilled in the U.S. to 1,525 last year, up from 1,252 when prices collapsed in 1999, says Philip H. "Pete" Stark, vice-president for industry relations at con-

JOHNSON could make money even if oil drops to \$25



THE STAT

**\$5
BILLION**

Conservative estimate of private equity earmarked for North American oil and gas exploration and production—double the level of three years ago

Data: EnCap Investments

TEXAS RIG Investors are betting on new fields, not just ones left by the majors



ENERGY

Why Bush Is Dipping Into Oil Reserves

In the midst of a tight Presidential race and with oil prices around \$50 per barrel, the Energy Dept. releases crude from the Strategic Petroleum Reserve. Is President George W. Bush pandering for votes while reneging on a promise to save the reserve for true emergencies? Democrats see the hint of a flip-flop. "Under the pressures the White House is seeing, it's not surprising that a chink would appear in the President's armor," says Elwood Holstein, a former Energy Dept. and Office of Management & Budget official who now advises the John Kerry campaign on energy issues.

Hard as it is to believe, though, the move to tap the SPR is more about an immediate need for oil than it is about politics. The Bush Administration acted in response to requests from three refiners, Shell Oil, Placid Refining, and ConocoPhillips that were running short of crude because of disruptions from Hurricane Ivan. The amount of crude released so far—3.2 million barrels, or the amount consumed nationally in four hours—is far too small to affect the price of oil. And the Energy Dept. continues to fill the reserve even as it fields requests for more loans of crude.

Tapping the strategic reserve is consistent with the Bush Administration's announced strategy. As recently as July, an Energy official testified before Congress that the department intended to make available crude from the SPR during periods of major supply disruptions, including natural disasters. Indeed, in October, 2002, the department released about 300,000 barrels as a result of shortages caused by Hurricane Lili.

Hurricane Ivan walloped the nation's most important oil-producing and importing region, the Gulf of Mexico. Tankers from Venezuela and elsewhere were diverted, and a number of oil-producing platforms were damaged. Even now the region's daily production rate is down nearly 30%.

As a result, a number of refiners found themselves short of crude. The releases will tide them over until production platforms in the gulf are repaired or staffed up again. For example, the Hunt brothers'

Placid Refining Co. of Port Allen, La., was running about 25% below capacity when it requested supplies from the reserve. The company got 300,000 barrels over the weekend of Sept. 24-26. That will keep the refinery operating at full capacity through the end of October, by which time things should be back to normal, says Placid Refining President Daniel Robinson.

In addition to being accused of emptying the reserve for political purposes, the Bush Administration faces



charges that it's keeping oil too expensive by continuing to fill the SPR. Oil-industry consultant Philip K. Verleger Jr. believes that government purchases have added \$4 or \$5 per barrel to the price of oil. Others would like to see Bush use the threat of future releases to cool the market. Says Tom Kloza, an analyst at the Oil Price Information Service: "By floating the notion that he would release more barrels, it would really send the markets down."

But that would be a major flip-flop for Bush. And considering that he is trying to sell himself to voters as a more consistent leader than rival John Kerry would be, it's a decision the President would have a hard time explaining. ■

—By Christopher Palmeri in Los Angeles
and John Carey in Washington

sulting firm IHS Energy Group. He figures that number could hit 1,875 this year, the most since 1990, with independents drilling the lion's share.

More players and more money mean more competition for acquisitions, people, services, and supplies. So is the industry setting itself up for sky-high costs and another bust? Executives and analysts insist their costs are under control and that the short supply of talent will limit injury in any case.

More important, the experienced players remain cautious and cost-conscious because of the pain they've suffered in past downturns. Jeff Johnson, CEO of Cano Petroleum Inc., which went public in June, figures his company could make money on its Oklahoma oil fields even if prices fell to \$25 a barrel. That's half where they stand now but still good compared with previous busts, when oil fell as low as \$10 a barrel. "We believe high oil prices are here to stay," says Johnson. He has a lot of smart money betting with him. ■

—By Wendy Zellner in Dallas

COMMENTARY

BY BEN ELGIN

Should Google Be in The Browser Biz? You Bet

Having its own Web entry is crucial for growth—and for keeping Microsoft at bay

MOST FOLKS FIGURED the “browser wars” had gone the way of Beta vs. VHS. But recent moves by Google Inc. have sparked speculation that the search giant could enter the browser business and restart competition in a market dormant since Microsoft Corp. squashed Netscape in the '90s. Consider the evidence. In recent months,

Google has hired techies with browser-building experience from the likes of Microsoft, Sun Microsystems, and BEA Systems. In addition, the company in April reserved the Web address www.gbrowser.com. Although insiders say no browser is imminent, analysts believe it's under strong consideration.

While eager investors have driven up Google's stock 55% since its August initial public offering, many analysts believe that to cement its long-term prospects Google should get into the browser business. Doing so would help it take on Microsoft on its own turf, move beyond search, and, by expanding its role as a point of entry to the Internet, allow it to sell more ads. “Developing a browser could be a necessity,” says Mark Mahaney, an analyst at American Technology Research Inc. Here's why Google should forge ahead on a browser—and the sooner the better:

EXPANDING WITHOUT CLUTTER Google has won adoration for a no-frills, fast-loading Web page that comprises just 37 words. But with Google moving beyond search into services such as e-mail, online groups, and photo management, it faces a dilemma: how to promote its services without cluttering up its search page.

A browser is the logical solution. Beyond the standard buttons such as “back” and “reload,” browsers typically display a toolbar for quick access to everything from bookmarked sites to often-used desktop software. A Google-flavored browser could highlight its range of services and bring them together without

forcing the search giant to junk up its site with logos and text.

Beyond acting as a one-stop shop for Google offerings, the browser would help the company make its various products work together seamlessly. For example, a Google browser could notify you when you receive an e-mail from certain people.

COLONIZING THE PC This is required real estate if the company is to achieve what many feel is an important future step in search: organizing data on people's hard drives, from pictures to Word files to e-mail. A browser could provide a launchpad to search these new realms, potentially yielding Google millions of additional search results around which it could sell its contextual ads.

True, Google is already establishing a presence on the desktop with a toolbar—software that attaches to existing browsers and provides instant access to Google search and other services. The company says downloads of its toolbar number in the millions. But most Web surfers are unaware that such toolbars exist, and a Google-branded browser could eclipse that. Consider that in the past two weeks people down-

loaded 2.5 million copies of an open-source browser built by a little-known outfit called the Mozilla Foundation. That shows how much demand there is for an alternative to Microsoft's browser. If Google were to put its brand behind an effort like that, just imagine the potential.

STAVING OFF REDMOND Microsoft owns about 94% of the browser market and is moving steadily into search. Sure, the software giant hasn't taken much advantage of the traffic delivered to its sites from buttons built into Internet Explorer. Nor has it marketed a feature that lets users simply type search queries into the browser's address box, taking them directly to an MSN search-results page. But some analysts say that once

Microsoft puts it all together, Google could be sorry.

Besides, much of the grunt work required to build a browser is already done. Google could simply piggyback on Mozilla's open-source technology, then devote its resources to customizing the browser for Google's myriad services. “If Google doesn't have a browser in three years, it could be a big hole in their business,” says Mahaney. It's a no-brainer. ■





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EDITED BY ROBIN AJELLO

HEADLINER

SALLIE KRAWCHECK



MOVING ON UP

Sallie Krawcheck is on the fast track. On Sept. 27, the 39-year-old chief executive of Citigroup's Smith Barney unit swapped jobs with Citi Chief Financial Officer Todd Thomson. Krawcheck has been called to the corporate suite to get to know Citi's overall global operations, say insiders. Some believe that she may be being groomed for a higher post down the road. As recently as the late '90s, Krawcheck was an analyst at research boutique Sanford C. Bernstein, where she was consistently ranked No. 1 among her peers covering the securities brokerage industry. She proved spirited and sometimes antagonistic—especially when sparring on conference calls with execs at the largest company she covered, Citigroup. Her smarts soon won her the CEO post at Bernstein, where she was recruited by Citigroup then-CEO Sanford Weill. He needed someone to clean house at his retail brokerage and stock research shop. She apparently met the challenge, hence her new promotion.

—Mara Der Hovanesian

NO CLEAN BILL OF HEALTH YET

McDonald's, which lately has cheered investors with its turnaround, gave them reason to worry anew on Sept. 28. The world's biggest burger chain said CEO Charles Bell has returned to the hospital to correct complications from surgery last May for colon cancer. In a statement, Bell said he underwent a second surgery in August to remove a blockage but has had to go back again for additional treatment. Bell, 43, took over McDonald's in late April after CEO James Cantalupo died of a heart attack. Under Cantalupo, Bell had been the clear No. 2 as chief operating officer. But while some nervous investors have urged Bell to name his own deputy, he has resisted, insisting he'll be around for the long haul.

CENDANT GOES INTO ORBITZ



Henry Silverman is back in the deal business. On Sept. 29, his travel and real estate company Cendant announced a \$1.25 billion cash deal to acquire online travel operator Orbitz. The move helps Cendant, until now an also-ran on the Web, move into the big leagues competing against the likes of Barry Diller's IAC/InterActive, which owns Expedia. "You have two

companies that generate a ton of cash and two astute financial buyers running them," says Timothy Fidler, director of research at Ariel Capital Management, which holds 12.9 million Cendant shares.

A WATCHDOG FOR WACHOVIA

The crackdown against improprieties in the mutual-fund business shows no signs of letting up. On Sept. 27, Charlotte (N.C.)-based Wachovia disclosed that investigators at the Securities & Exchange Commission may recommend enforcement action against its retail brokerage unit for improper fund trading. At issue: an alleged deal between a Wachovia Securities broker and a former employee at its Evergreen mutual-fund unit who made excessive trades for a client in the bank's Evergreen Mid Cap Growth fund between December, 2000, and April, 2003. In August, Wachovia said the SEC was also investigating possible improper short-term trading by a former manager of Evergreen Precious Metals fund. Wachovia, the nation's fifth-largest bank, said it intends to respond to the SEC and will argue that enforcement action is not warranted.

SCRUSHY UNDER SIEGE

Things just got worse for Richard Scrushy. On Sept. 29, federal prosecutors filed a new indictment accusing the former HealthSouth CEO of perjury and obstruction of justice—adding to existing charges of fraud and conspiracy. The Justice Dept. now contends Scrushy lied to

an SEC attorney when he claimed statistics in a 2001 financial report filed by the rehabilitation chain were accurate, and that he hadn't ordered anyone to alter figures. Scrushy has pleaded not guilty to all charges stemming from a \$2.6 billion accounting scandal at HealthSouth. He also says other executives committed accounting irregularities without his knowledge.

ET CETERA...

- » Computer Associates will lay off 5% of its workers.
- » Martha Stewart will do her time in West Virginia, not Connecticut, as she hoped.
- » Wal-Mart is buying back \$10 billion worth of shares.

CLOSING BELL

Caterpillar, riding what it called an "unprecedented" rise in demand for its machines and engines, on Sept. 28 hiked its 2004 sales forecast and said '05 results would be higher still. Shares of the bellwether stock hit \$80.50 on Sept. 29, a two-day increase of 8%.



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VIAGRA is prescribed to treat erectile dysfunction. We know that no medicine is for everyone. If you use nitrate drugs, often used for chest pain (known as angina), don't take VIAGRA. Taking these drugs together could cause your blood pressure to drop to an unsafe level.

The most common side effects of VIAGRA are headache, facial flushing, and upset stomach. Less common are bluish or blurred vision, or being sensitive to light. These may occur for a brief time. Remember to protect yourself and your partner from sexually transmitted diseases.

Talk with your doctor first. Make sure you are healthy enough to have sex. If you have chest pain, nausea, or other discomforts during sex, seek medical help right away. The same is true if you have an erection that lasts more than 4 hours. Call for help at once.

VIAGRA is covered under most Managed Care Plans.

* For some men, in as quickly as 10 minutes; for most, in under a half hour (statistical significance at 14 minutes). In this study, VIAGRA responders, given 100 mg 2 hours after eating, were timed to see how fast they got an erection that enabled them to have sex.

† Data on file. Pfizer Inc., New York, NY

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PATIENT SUMMARY OF INFORMATION ABOUT

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This summary contains important information about VIAGRA®. It is not meant to take the place of your doctor's instructions. Read this information carefully before you start taking VIAGRA. Ask your doctor or pharmacist if you do not understand any of this information or if you want to know more about VIAGRA.

This medicine can help many men when it is used as prescribed by their doctors. However, VIAGRA is not for everyone. It is intended for use only by men who have a condition called erectile dysfunction. **VIAGRA must never be used by men who are taking medicines that contain nitrates of any kind, at any time. This includes nitroglycerin. If you take VIAGRA with any nitrate medicine your blood pressure could suddenly drop to an unsafe or life threatening level.**

• What Is VIAGRA?

VIAGRA is a pill used to treat erectile dysfunction (impotence) in men. It can help many men who have erectile dysfunction get and keep an erection when they become sexually excited (stimulated).

You will not get an erection just by taking this medicine. VIAGRA helps a man with erectile dysfunction get an erection only when he is sexually excited.

• How Sex Affects the Body

When a man is sexually excited, the penis rapidly fills with more blood than usual. The penis then expands and hardens. This is called an erection. After the man is done having sex, this extra blood flows out of the penis back into the body. The erection goes away. If an erection lasts for a long time (more than 6 hours), it can permanently damage your penis. You should call a doctor immediately if you ever have a prolonged erection that lasts more than 4 hours.

Some conditions and medicines interfere with this natural erection process. The penis cannot fill with enough blood. The man cannot have an erection. This is called erectile dysfunction if it becomes a frequent problem.

During sex, your heart works harder. Therefore sexual activity may not be advisable for people who have heart problems. Before you start any treatment for erectile dysfunction, ask your doctor if your heart is healthy enough to handle the extra strain of having sex. If you have chest pains, dizziness or nausea during sex, stop having sex and immediately tell your doctor you have had this problem.

• How VIAGRA Works

VIAGRA enables many men with erectile dysfunction to respond to sexual stimulation. When a man is sexually excited, VIAGRA helps the penis fill with enough blood to cause an erection. After sex is over, the erection goes away.

• VIAGRA Is Not for Everyone

As noted above (*How Sex Affects the Body*), ask your doctor if your heart is healthy enough for sexual activity.

If you take any medicines that contain nitrates – either regularly or as needed – you should never take VIAGRA. If you take VIAGRA with any nitrate medicine or recreational drug containing nitrates, your blood pressure could suddenly drop to an unsafe level. You could get dizzy, faint, or even have a heart attack or stroke. Nitrates are found in many prescription medicines that are used to treat angina (chest pain due to heart disease) such as:

- nitroglycerin (sprays, ointments, skin patches or pastes, and tablets that are swallowed or dissolved in the mouth)
- isosorbide mononitrate and isosorbide dinitrate (tablets that are swallowed, chewed, or dissolved in the mouth)

Nitrates are also found in recreational drugs such as amyl nitrate or nitrite ("poppers"). If you are not sure if any of your medicines contain nitrates, or if you do not understand what nitrates are, ask your doctor or pharmacist.

VIAGRA is only for patients with erectile dysfunction. VIAGRA is not for newborns, children, or women. Do not let anyone else take your VIAGRA. VIAGRA must be used only under a doctor's supervision.

• What VIAGRA Does Not Do

- VIAGRA does not cure erectile dysfunction. It is a treatment for erectile dysfunction.
- VIAGRA does not protect you or your partner from getting sexually transmitted diseases, including HIV — the virus that causes AIDS.
- VIAGRA is not a hormone or an aphrodisiac.

• What To Tell Your Doctor Before You Begin VIAGRA

Only your doctor can decide if VIAGRA is right for you. VIAGRA can cause mild, temporary lowering of your blood pressure. You will need to have a thorough medical exam to diagnose your erectile dysfunction and to find out if you can safely take VIAGRA alone or with your other medicines. Your doctor should determine if your heart is healthy enough to handle the extra strain of having sex.

Be sure to tell your doctor if you:

- have ever had any heart problems (e.g., angina, chest pain, heart failure, irregular heart beats, heart attack or narrowing of the aortic valve)
- have ever had a stroke
- have low or high blood pressure
- have a rare inherited eye disease called retinitis pigmentosa
- have ever had any kidney problems
- have ever had any liver problems
- have ever had any blood problems, including sickle cell anemia or leukemia
- are allergic to sildenafil or any of the other ingredients of VIAGRA tablets
- have a deformed penis, Peyronie's disease, or ever had an erection that lasted more than 4 hours
- have stomach ulcers or any types of bleeding problems
- are taking any other medicines

• VIAGRA and Other Medicines

Some medicines can change the way VIAGRA works. Tell your doctor about **any medicines** you are taking. Do not start or stop taking any medicines before checking with your doctor or pharmacist. This includes prescription and nonprescription medicines or remedies:

- Remember, VIAGRA should never be used with medicines that contain nitrates (see *VIAGRA Is Not for Everyone*).
- If you are taking alpha-blocker therapy for the treatment of high blood pressure or prostate problems, you should not take a dose of greater than 25 mg of VIAGRA at the same time (within 4 hours) as you take your dose of alpha-blocker.
- If you are taking a protease inhibitor, your dose may be adjusted (please see *Finding the Right Dose for You*).
- VIAGRA should not be used with any other medical treatments that cause erections. These treatments include pills, medicines that are injected or inserted into the penis, implants or vacuum pumps.

• Finding the Right Dose for You

VIAGRA comes in different doses (25 mg, 50 mg and 100 mg). If you do not get the results you expect, talk with your doctor. You and your doctor can determine the dose that works best for you.

- Do not take more VIAGRA than your doctor prescribes.
- If you think you need a larger dose of VIAGRA, check with your doctor.
- VIAGRA should not be taken more than once a day.

If you are older than age 65, or have serious liver or kidney problems, your doctor may start you at the lowest dose (25 mg) of VIAGRA. If you are taking protease inhibitors, such as for the treatment of HIV, your doctor may recommend a 25 mg dose and may limit you to a maximum single dose of 25 mg of VIAGRA in a 48 hour period. If you are taking alpha-blocker therapy, you should not take a dose of greater than 25 mg of VIAGRA at the same time (within 4 hours) as your dose of alpha-blocker.

• How To Take VIAGRA

Take VIAGRA about one hour before you plan to have sex. Beginning in about 30 minutes and for up to 4 hours, VIAGRA can help you get an erection if you are sexually excited. If you take VIAGRA after a high-fat meal (such as a cheeseburger and french fries), the medicine may take a little longer to start working. VIAGRA can help you get an erection when you are sexually excited. You will not get an erection just by taking the pill.

• Possible Side Effects

Like all medicines, VIAGRA can cause some side effects. These effects are usually mild to moderate and usually don't last longer than a few hours. Some of these side effects are more likely to occur with higher doses. The most common side effects of VIAGRA are headache, flushing of the face, and upset stomach. Less common side effects that may occur are temporary changes in color vision (such as trouble telling the difference between blue and green objects or having a blue color tinge to them), eyes being more sensitive to light, or blurred vision.

In rare instances, men have reported an erection that lasts many hours. You should call a doctor immediately if you ever have an erection that lasts more than 4 hours. If not treated right away, permanent damage to your penis could occur (see *How Sex Affects the Body*).

Heart attack, stroke, irregular heart beats, and death have been reported rarely in men taking VIAGRA. Most, but not all, of these men had heart problems before taking this medicine. It is not possible to determine whether these events were directly related to VIAGRA.

VIAGRA may cause other side effects besides those listed on this sheet. If you want more information or develop any side effects or symptoms you are concerned about, call your doctor.

• Accidental Overdose

In case of accidental overdose, call your doctor right away.

• Storing VIAGRA

Keep VIAGRA out of the reach of children. Keep VIAGRA in its original container. Store at 25°C (77°F); excursions permitted to 15-30°C (59-86°F) [see USP Controlled Room Temperature].

• For More Information on VIAGRA

VIAGRA is a prescription medicine used to treat erectile dysfunction. Only your doctor can decide if it is right for you. This sheet is only a summary. If you have any questions or want more information about VIAGRA, talk with your doctor or pharmacist, visit www.viagra.com, or call 1-888-4VIAGRA.



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September 2002

BY RICHARD S. DUNHAM

Poll Overload: How to Cut Through the Clutter

ARKANSAS GOVERNOR MIKE HUCKABEE has been around politics for a long time, but even he is confused by the onslaught of often-conflicting public opinion polls out there in the 2004 campaign. "It's like poll soup," he says. "You stick your spoon in, and you don't know what you're going to get out of it." Huckabee, a Re-

publican, isn't the only one in what he calls "a poll haze" these days. With media outlets feeding the 24/7 news beast, Americans have been bombarded by an unprecedented number of Presidential polls—80 in the past three months, 33 in the first 27 days of September alone. The disparate results have set off a furious debate among political veterans and Internet chatting heads. In an era of unlisted cell phones and do-not-call lists, are telephone polls reliable? And are Americans being misled by error-prone "quick and dirty" polls conducted for publicity-hungry media organizations? "All polls are not created equal," says Gary Langer, polling director for ABC News. "Some are good, and some are junk."

So how do you sift through this numerical jumble? Here are a few hints:

LOOK FOR TRENDS. Individual polls are often unreliable because of their margin of error, usually plus or minus three percentage points. That means two polls finding candidates in a dead heat at 45%-45% or at 52%-42%, as happened in late September, could be telling the same story. But if polls show just one candidate gaining, opinion is almost certainly moving that way. For example, George W. Bush trailed John Kerry in 14 of the 24 national polls in August, with the Prez ahead in 6 and tied in 4. But Bush had the upper hand in 28 of the first 33 September surveys, vs. just 1 for Kerry. The rest were tied. Undeniably, the momentum was with Bush.

BEWARE THE OUTLIERS. One rule of media coverage: The bigger the shift in a single poll, the louder the buzz. So a Sept. 13-15 Gallup survey giving Bush a 14-point lead among likely voters got a huge amount of

publicity, even though 7 of the 8 other polls conducted that week showed a margin less than half the size. One way to figure out the real state of play is to scan the most recent polls. (A good Web site is realclearpolitics.com.) If you take the 10 most recent surveys, eliminate the extremes, and average the rest, Bush led Kerry by 6.3 points on the eve of the debates. This "poll of polls" isn't scientifically valid, but it is a good unofficial cheat sheet.

CHOOSE YOUR POISON. If you think most '04 polls are stacked against Dems, Zogby is the poll for you because it adjusts its numbers to account for party affiliation. GOP partisans will like the Fox News/Opinion Dynamics Poll, whose results have generally been more favorable to Bush. Closest to the statistical center is the Associated Press/Ipsos Poll. (Its survey released on Sept. 26 gives Bush a seven-point lead.) Once you pick the one you like best, stick with it: Trends are more important than the snapshot of a single poll.

SILENCE THE SPINNERS. It's a good idea to ignore partisan talking heads. For example, Kerry campaign manager Mary Beth Cahill sent an e-mail on Sept. 24 saying that "five new national polls this week show the race tied." Actually, 10 new polls showed Bush ahead, but 5 were within the margin of error.

FORGET POLLS. Besides data overload, there are two new reasons to ignore surveys entirely: They could be missing the real picture because most measure "likely" voters and might not reflect a recent surge in registrations. And they could be flawed by failing to take into account people who either routinely screen their calls or have abandoned land-line phones. ■



CAHILL Partisans only obscure the already confusing data avalanche

CAPITAL WRAPUP

HIRE A DEMOCRAT, PAY A PRICE?

REPUBLICANS WERE none too happy when Hollywood tapped a prominent Democrat, former Kansas congressman and Clinton Cabinet member **Dan Glickman**, to take the helm of the industry's high-profile lobby shop. Now revenge could be at hand. Republicans are talking of torpedoing legislation coveted by the Motion Picture Association of America. The bill, which would make camcording films a felony punishable by up to six years in prison, passed the House on Sept. 28 and should be on its way to final negotiations with the Senate. But GOPers are talking about deep-sixing that provision. It's the only legislation Republicans can kill to hurt the MPAA without causing too much collateral damage to the more obedient Recording Industry Association of America, which last year hired a well-connected Hill Republican—**Mitch Bainwol**—to fill its top job.

KERRY HAS NO PRAYER WITH BORN-AGAINISTS

IN A NATION fundamentally divided along cultural lines, the factor most closely tied to Presidential preferences may well be whether a voter is a born-again Christian. President **George W. Bush** leads **John Kerry** in all 16 states where 30% or more of the population is fundamentalist Protestant, according to a *BusinessWeek* analysis of data released on Sept. 27 by the National Annenberg Election Survey. Of eight states where evangelicals account for less than 20% of residents, the Democrat leads in six. (Heavily Mormon Utah and strongly Catholic Wisconsin are the exceptions.) Fourteen small-population states were not included in the results.



CHINA

NOW COLLEGE GRADS CAN'T FIND A JOB

With more and more Chinese attending university, they're facing frustration when they get out

IF ANY STUDENT TRYING TO ENTER the workforce in China should have an easy time finding a plum job, it's Wang Zhaohui. In July, the 30-year-old graduated from China Agricultural University in Beijing—China's top agriculture academy—with a PhD in biochemistry and molecular biology. That makes him well-

positioned to take advantage of the government's drive to upgrade its competitiveness in science and technology. But for months now, Wang has been seeking a position with a university, research center, or biotech company—and has had no luck. He says many classmates are having similar trouble. "I am so disappointed," he says, adding that his hoped-for salary

of \$725 a month might be unrealistic. "I have already lowered my expectations, and I may have to lower them further."

Around the world, it's hardly unusual for people fresh out of university or graduate school to have trouble landing a job. Until recently, though, China was the exception. For many years only the top 4% of China's students could enroll in col-

BEIJING JOB
MARKET Will
it swell?

lege, and there were plenty of white-collar jobs to go around. But since the late 1990s public universities have undergone rapid expansion both on their main campuses and satellites around the country. People's University, Beijing Normal University, and China Medical University have all opened campuses in the booming southern city of Zhuhai. Private-sector schools, both Chinese and foreign, have also proliferated.

With all this expansion, more than 17% of the country's college-age students can now find places in universities. The number of university graduates has exploded from 1.5 million in 2002 to 2.8 million this year. In 2005 the system is expected to produce 3.4 million. "China has taken off like a rocket," says Mark Bray, dean of the education faculty at the University of Hong Kong. "There are huge numbers of graduates coming out of the pipeline."

The problem is that even in China, the world's fastest growing economy, there aren't enough jobs for so many graduates—and President Hu Jintao and Premier Wen Jiabao have a new kind of production overcapacity to grapple with. On Sept. 28, Lin Huiqing, director of the Education Ministry's college students department, told reporters that some 30% of this year's grads are unemployed and that the increase in graduates was aggravating an already difficult job market.

Economists estimate that the jobless rate in China's urban areas ranges between 8% and 10%, with many of the unemployed workers coming from uncompetitive state-owned enterprises in China's rust belt that have been shut down. Labor activists in Hong Kong say that disgruntled workers are striking to protest the privatization of their companies. For instance, 7,000 Chinese textile workers near the ancient capital of Xian walked off their jobs on Sept. 13 after the new owners of their factory cut wages and benefits.

The government is keen to prevent this blue-collar anger from spreading to the

ranks of college graduates—especially since China has a history of intellectuals taking the lead in social protests. Students were at the forefront of the 1989 Tiananmen Square protests, for instance.

Admittedly, university campuses in China today are hardly hotbeds of political activity. "The days when students and intellectuals acted as a tinder in society are a bit passé," says Robin Munro, research director at *China Labour Bulletin*, a worker-rights publication in Hong Kong. Nonetheless, the Education Ministry is eager to get unemployed college graduates into the workforce fast. The ministry is urging jobless grads to start their own companies, with some local governments offering loans to give a hand to would-be entrepreneurs. Young grads are also being urged to join Hu and Wen's campaign to spread prosperity to the interior. Last year the Education Ministry and the Communist Youth League launched a Peace Corps-like program to send recent graduates to impoverished regions in western China. According to the Chinese press, over 10,000 volunteers have signed up for this Go West program.

BIG-CITY BIAS

MOVING TO THE boondocks isn't a practical solution for most graduates, however. Having made it through university, they want to live in comfort and make good money working in places such as Beijing, Shanghai, or Shenzhen. "There is much more opportunity to develop myself in a big city like Beijing," says 27-year-old Zhang Jing, who recently earned a degree in journalism at the Beijing campus of the Communication University of China but has a temporary job as a teacher for \$100 a month. "The salary and work conditions are usually much better than in small cities."

The big cities are also where the big-name local companies and blue-chip multinationals are located. Problem is, while such employers badly need experienced managers and researchers, they "are not coming [to China] for fresh graduates," says Jun Ma, an economist with Deutsche Bank in Hong Kong. He points out that while there is great demand for engi-

Companies are looking for people who have several years' experience

The graduate glut is one more sign of how difficult it is for China to manage a smooth transition to a market economy. Not too long ago, college graduates who did not land jobs in the nascent private sector were virtually guaranteed spots in government ministries or state-owned enterprises. With agencies and SOEs slimming down, those easy berths aren't available in great numbers any more.

What's more, Beijing may have unwittingly compounded its problem: It increased college enrollments partly as a way to keep a rising tide of high school graduates from flooding the labor market too early. That move postponed the employment problem for many of China's young people but did nothing to solve it.

Of course, in the long run, expanding the college student population is a key to development: China's huge supply of young, educated workers is crucial to its drive to achieve First World status. And even with 17% of its college-age people in school, China lags behind industrialized countries, where the proportion is 40% or more. Over time, making it easier for people to go to university will help upgrade the workforce, as cities such as Guangzhou shift away from labor-intensive manufacturing and develop their service industries.

For now, though, people like Wang are growing impatient. Wang says he's thinking of leaving China for a postdoctoral position in the U.S. "It is proving not worth the time or energy to search for work in China," he says. Of course, with visas to the U.S. increasingly hard to get, that's not necessarily an easy way out, either. China's college-educated elite can count on more frustration as they search for the jobs that match their skills. ■

—By Bruce Einhorn in
Hong Kong and Dexter
Roberts in Beijing

GRADUATE GLUT





JAPAN

SO MUCH FOR HOLLOWING OUT

Japan's giants are investing in plants at home again. Why the switch?

LYING 500 MILES SOUTH OF Tokyo on the island of Kyushu, Oita prefecture is hardly the kind of place you would expect to find the trendsetting titans of Japan Inc. Until recently the biggest contributors to the economy in bucolic Oita were the hot spring resorts in the coastal town of Beppu.

But this year, Oita is flourishing as Japan's corporate giants invest billions in new manufacturing plants. Canon Inc. is building a 310,000-square-foot digital camera facility near Beppu Bay. Down the road in Oaza Matsuoka, Toshiba Corp. in October plans to open a semiconductor plant. And auto producer Daihatsu Motor Co. is building a factory in nearby Nakatsu. "These companies are activating the economy," says Kazuhiro Nakao, who oversees the prefecture's efforts to attract investment.

It's not just Oita's economy that's being activated these days. After years of hand-wringing by authorities over the hollowing out of Japan's manufacturing indus-

tries, Corporate Japan is investing at home again. Despite the recent sell-off on the Tokyo markets and slowing economic growth, expenditures on plants and equipment in Japan will likely grow by 10% this year, the Japan Research Institute says. More important, the money today is being used to ramp up capacity. That's a big change from the lean post-bubble years, when new spending was usually earmarked for technologies to keep up with competitors or to bring costs down. "This is the anti-hollowing out," says Jesper Koll, chief Japan analyst at Merrill Lynch & Co.

Companies big and small are investing across Japan. In the central city of Kameyama, Sharp Corp. in August boosted capacity at its LCD TV plant

by 80%, to 27,000 sets monthly. In Hyogo, 62 miles to the west, Matsushita and chemicals producer Toray are investing \$860 million in a plasma display plant that will churn out 3 million TVs annually when it opens next year. In September, Nippon Steel Corp. said it plans to spend \$360 million retooling facilities to boost production by 7%. And tofu maker Shinozakiya Inc. plans to build a \$9.2 million factory in Tochigi prefecture.

PROTECTION FROM PIRATES

WHY THE SHIFT? One reason is that Japanese companies have already reaped many of the potential gains from moving production overseas. In the past decade the share of Japanese-owned productive capacity located abroad has grown to 45% from just 8%, Merrill Lynch estimates. That's almost as high as the U.S.'s 50%, which means Japan Inc. overall now has a competitive cost structure. Canon, after making 80% of its capital investments overseas for the past decade, today has 42% of its total production abroad. Now the company is pledging to spend 80% of the \$7.2 billion in capital outlays it plans for the next three years at home. "With factory automation and other production techniques, we can manufacture certain goods at a lower cost in Japan," Canon CEO Fujio Mitarai remarked in a statement.

Then there's the question of security. Japanese manufacturers are eager to protect themselves from intellectual-property pirates by keeping production at home. Many say their Japanese employees are far more loyal than those abroad—typically staying with the company for their entire careers—so they're less likely to walk off with knowledge of the latest developments.

Japanese companies, of course, will still open new plants abroad. Auto man-

ufacturers continue to build up in the U.S. and China, and electronics makers Sharp, Canon, and Toshiba have no plans to close existing Chinese operations, particularly given their high hopes for fast growth in the mainland. But that scary feeling that Japan had no future as a manufacturing center is finally starting to ebb. ■

—By Ian Rowley
in Tokyo

REBUILDING JAPAN INC.

After a long pause, Japanese companies are investing in new plants and equipment again





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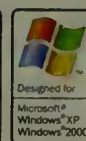
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Global Accounting Firm Grant Thornton Uses Centra to Collaborate

Grant Thornton, a leading global accounting, tax, and business advisory organization, turned to Centra as part of a corporate initiative to create a continuous learning culture across the firm.

According to Bob Dean, Grant Thornton's chief learning officer, "Connecting online with practice and technical leaders from across the firm's 48 U.S. locations was a main driver in our decision to implement Centra, allowing us to deliver knowledge to our tax and assurance practices in days, not months."

Partners and employees use Centra for a range of activities, from competency training to updates on accounting and tax issues. When the Sarbanes-Oxley Act passed, Grant Thornton used Centra to quickly mobilize 700-plus employees within two weeks. "We were able to react immediately and deliver a consistent message to clients," says David Holyoak, Grant Thornton's CIO. "We were prepared, pro-active and unified in our response."

Grant Thornton continues to leverage Centra to control costs, improve continuing education and employee orientation, and enhance firm-wide communications. Dean summarizes, "We rely on Centra as a vital application for achieving the high levels of professional development and corporate communication mandated by our industry."



COMMENTARY

BY JOHN ROSSANT

Turkey at the EU's Door

It has key allies, but opposition to its entry is rising

TURKEY'S decades-long quest to join the European Union looks set to take a great leap forward. On Oct. 6 the European Commission in Brussels is due to release its opinion on

whether Turkey has met the legal conditions to start negotiations on becoming a full EU member. Then, in mid-December, Europe's 25 political leaders are scheduled to give their formal consent to opening negotiations.

Listen to the official noise coming out of Brussels and Ankara, and it sounds as if Turkey has nothing to worry about. For Günter Verheugen, the EC's Enlargement Commissioner, "no remaining obstacles are on the table." Conservative Turkish Prime Minister Recep Tayyip Erdogan, who has turned getting a green light from Europe into a personal political crusade, is similarly upbeat: "There is no reason not to receive a positive answer," he said on Sept. 23.

Don't think this is the end game, though. Far from it. Anxieties about the wisdom of incorporating Turkey into the EU are rising across Europe. In recent weeks, influential EC commissioners like Franz Fischler and Frits Bolkestein have warned about the consequences of letting an overwhelmingly Muslim Near Eastern state of 75 million into the EU.

Given demographic trends, Turkey would be the most populous EU nation in 15 years. French Finance Minister Nicolas Sarkozy, a likely presidential candidate in 2007, is even calling for a national referendum on Turkish EU membership. Recent polls by the German Marshall Fund suggest that only about one-third of Europeans support Turkey's entry into the EU.

A grassroots opposition to Turkey's candidacy could also weaken the EU itself. Sylvie Goulard, a former top adviser to the EC President, argues that a green light to Turkey in December in the face of rising popular opposition could undercut attempts to win approval for Europe's draft constitution in a series of referendums in 2005 and 2006. "You can't spread democracy without respecting it," says Goulard, referring to the way EU leaders often make important decisions behind closed doors.

Is there a way out? One would be to give Turkey a go-ahead in December, while making it clear that EU membership is not guaranteed at the end of negotiations. That would be quite a switch: No country has begun accession negotiations and then failed to win full membership. Yet an open-ended solution has attractions for both sides. It would allow Erdogan to continue economic

reforms, opening the way to badly needed foreign investment. And it would give European leaders temporary cover from a voter backlash. But given the volatile political climate, that may be a difficult balancing act. Turkey's entry into the EU? It's far from a sure thing. ■



The EU may agree to negotiate—but not guarantee admission

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RUSSIA

THE YANK CAUGHT IN YUKOS' NIGHTMARE

CEO Steven Theede has a thankless job: Trying to hold the company together

BY A CURIOUS TWIST OF fate, the job of rescuing Russian oil giant Yukos has fallen to an American who arrived in Moscow just over a year ago—and who still needs a translator's help. Steven M. Theede, a 30-year veteran of U.S. oil major ConocoPhillips and a native of the Kansas farm belt, now has the unenviable task of managing a company that could soon be torn to pieces to settle a huge tax bill.

It's not exactly the role Theede thought he would play in the spring of 2003 when he first met Yukos' main owner, Mikhail B. Khodorkovsky, at the Ritz Hotel in London. Khodorkovsky had already turned Yukos into one of Russia's most modern companies and was keen to attract seasoned Western managers. "I was impressed with his vision of the future of the company," says Theede, 52, who quit his job as ConocoPhillips' president for exploration and production in Europe, Russia, and the Caspian to become Yukos' chief operating officer. It sounded like "an exciting challenge," he adds.

Maybe a bit more exciting than he bargained for. By October, 2003, Khodorkovsky was behind bars, facing charges of fraud and tax evasion—politically motivated charges, according to Khodorkovsky, who resigned as CEO shortly afterward. But that didn't stop the government from hitting Yukos with billions of dollars in back-tax claims relating to the use of tax havens, which Yukos insists were legal. It was hardly the best starting point for Theede, who took over as CEO in June, replacing Simon G. Kukes, a Rus-

ian oil veteran who had been unable to stem the Kremlin's assault. Perhaps shareholders thought that by picking an untainted American, they would soften the blows raining down on the company.

If so, they thought wrong. Yukos faces a back-tax bill of \$7 billion, with more claims pending. To settle the debt, the Kremlin plans to sell Yuganskneftegaz, Yukos' largest production subsidiary. Theede started out believing that if Yukos made its own proposals, such as paying the disputed taxes in installments, or paying with Yukos shares, the company could avoid losing such assets. Now he's growing pessimistic. "When you step back from all our proposals and all the comments by officials, it still seems that the first choice [of the government] would be to take away major core assets. Of course, only time will tell," he adds.

While Theede portrays himself as cautious, his defensive tactics have raised eyebrows. Yukos has warned more than once that it is on the brink of bankruptcy and could be forced to suspend production or exports because the government has frozen bank accounts. Some analysts accuse

BIO

Steven Theede

How he found his way to Yukos

1952 Born in Hutchison, Kan.

1974 Graduates from Kansas State University with a degree in mechanical engineering. Joins Conoco and spends the next 28 years as a manager in production, refining, and marketing in the U.S. and Britain.

2002 Named president for

exploration and production for Europe, Russia, and the Caspian.

AUGUST, 2003 Moves to Russia to take up the new position of chief operating officer for Yukos.

JUNE 24, 2004 Elected chief executive officer at the Yukos annual general meeting.

Data: Yukos, BusinessWeek



THEEDE The post sounded like "an exciting challenge"

Yukos of playing up these woes to embarrass the Kremlin. Theede denies this. He feared the government might end up bankrupting Yukos by accident, and he wanted to give them the full facts. "We were trying to educate, not threaten," he says.

50-50 SPLIT

DESPITE THE KREMLIN'S attack on the company, Yukos' production was up 8.7% in the first six months of the year, while exports grew 11.4%. According to Moscow investment bank Renaissance Capital, revenues will be \$21 billion, up from \$16.5 billion last year, with cash flow growing to \$6.4 billion from \$5.5 billion.

Of course, money doesn't do you any good if you don't have access to it. Yukos says more than half of its \$2 billion-a-month revenues are seized by the government to cover the tax debt. Yukos has so far managed to avoid bankruptcy through savage cuts in expenditures and a default on \$120 million in natural-resource taxes in August. Russia's Natural Resources Ministry has threatened to withdraw production licenses from Yuganskneftegaz if the taxes aren't paid.

So how does Theede feel about this crash course in Russian business and politics? "I'm not in a position to make negative comments about things in Russia. I want to depoliticize my role and stay focused at the business level," he says. A worthy objective. But maybe, in the case of the Yukos affair, a hopeless one. ■

—By Jason Bush in Moscow

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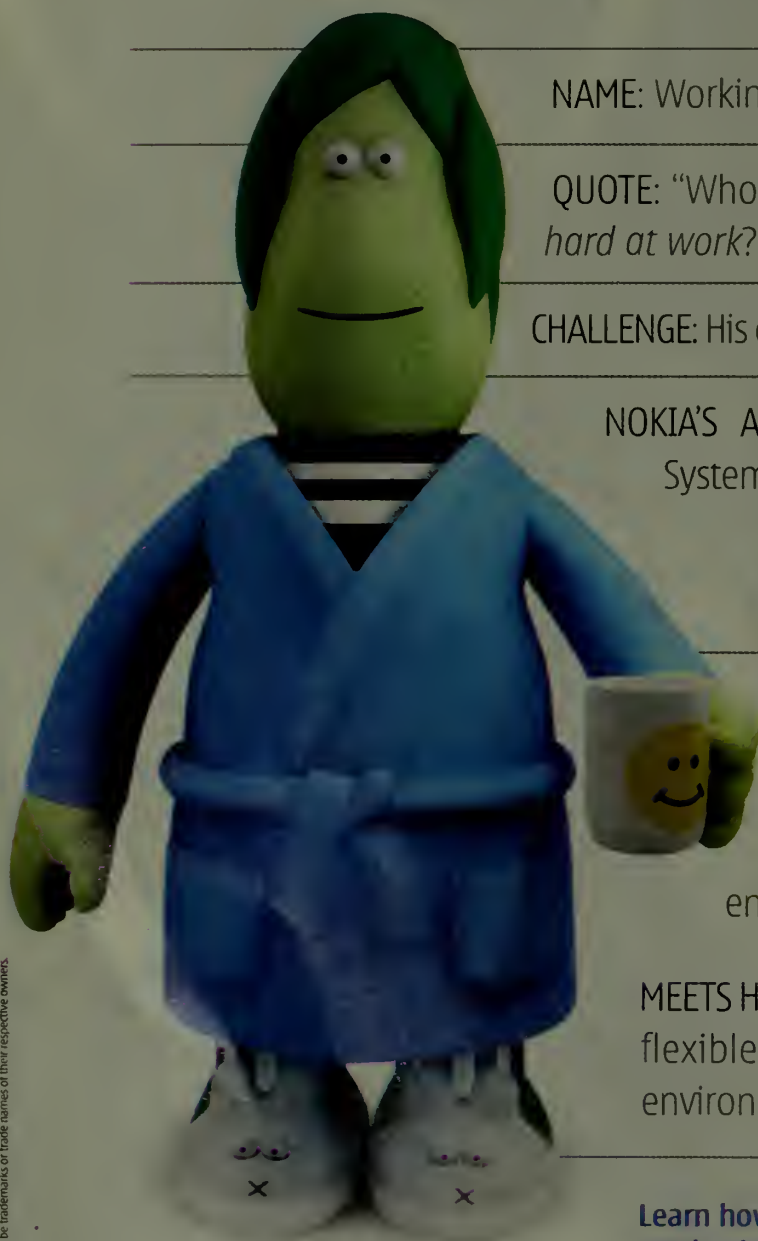


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Why Nigeria Will Rock Oil Markets Again

JUST ABOUT ANYTHING WILL SCARE oil traders these days. So it's not surprising that fighting between the Nigerian military and a rebel militia group in the Niger Delta, Nigeria's key oil-producing region, helped push prices over \$50 per barrel in late September. Then, on Sept. 29, the rebels announced a temporary cease-fire

with the government of President Olusegun Obasanjo, and the upward pressure on oil briefly eased. End of story? Hardly. Other threats to the oil supply in Nigeria are bound to occur, given the fractious state of regional politics in that huge African country. What's more, Nigeria, Angola, and other West African nations are becoming increasingly important producing areas for the major oil companies. In 2003, for instance, output from Royal Dutch/Shell's joint venture in Nigeria accounted for about 10% of its world output. Paris-based Total is a big player, too. All told, proven reserves in West Africa come to 47 billion barrels. And the companies are investing heavily in liquefied natural gas facilities in the area.

Slippery Terrain

THE U.S. AS WELL is taking a greater interest in Nigeria, and providing the government with military training. The Bush Administration sees Nigeria's oil as a promising alternative to Mideast crude. But given the turbulence in the Niger Delta, greater reliance on Nigerian oil poses its own set of risks. The Delta people, who comprise many ethnic groups and number 10 million to 15 million, have long blamed Big Oil and the government for turning their riverine home into a wasteland and for not sharing enough revenue to compensate. "They have done the least well out of so-called economic development," says Richard Jeffries, a lecturer on African politics at London's School of Oriental & African Studies. In the Delta, however, the line between criminality and politics is muddy:

Criminal gangs try to extort money from the oil companies and steal some 9 million barrels of oil a year, say industry sources.

"The Potential to Get Worse"

THE FEROCITY of the recent strife has been alarming. Hundreds of people have been killed since the military cracked down on the Niger Delta People's Volunteer Force. The militia, which is well organized, wants self-determination for the region and control over the local oil industry. Recently the militia leader, Mujahid Dokubu-Asari, warned expatriate workers to leave the area for their own safety: He repeated his threat even after agreeing to the cease-fire. Shell evacuated more than 200 nonessential employees and shut down about 28,000 bbl. per day of production at one installation.

Despite the cease-fire, the larger question of stability remains. Earlier this year a consultants' report commissioned by Shell raised the question of whether the violence would one day drive it out of the area. Shell acknowledges that the conflict has "the potential to get worse" and says it is trying to ease tensions. But a spokesman says it remains committed to Nigeria.

What's the worst-case scenario? Roger Diwan, an analyst at PFC Energy in Washington, thinks that if serious fighting erupts again the rebels might be able to disrupt 300,000 to 400,000 bbl. per day of Nigeria's 2.3 million bbl. production. A more likely outcome would be chronic unrest that sends prices skyward at critical moments. With supplies as tight as they are, that's a troubling scenario as well. ■

—By Stanley Reed in London



OIL FIELD Shell produced 10% of its world output in Nigeria last year

GLOBAL WRAPUP

BUYING A PIECE OF RUSSIA

CONOCOPHILLIPS has big plans for Russia. On Sept. 29 the U.S. oil major bought a 7.59% stake in Lukoil, Russia's biggest oil company, paying \$1.99 billion in Russia's largest privatization ever. Conoco may up its stake to 20% within two or three years. Its investment comes despite continuing investor concern over the fate of Yukos, which the government may soon dismantle to settle the company's huge tax debts. But unlike Yukos, Conoco can draw comfort from the support of President Vladimir V. Putin, who has warmly endorsed the Conoco-Lukoil partnership.

BIRD FLU IN THAILAND: NEW FEARS

THE DEATH OF a 26-year-old Bangkok woman on Sept. 20 is raising fears that deadly avian flu may be "learning" how to spread among people—a step towards a potentially devastating epidemic. A total of 30 people have now died from so-called bird flu in Thailand and Vietnam, but until now, World Health Organization officials concluded that victims contracted the disease through direct contact with infected poultry. The WHO believes the Thai woman may have gotten the virus from her daughter, who also died. Scientists are hoping that the case is a rare event and not evidence of a new, more transmissible strain of avian flu. What everyone is concerned about, says a WHO spokesman, is that the bird virus will mix with genes from the human flu virus "and ignite a pandemic." Asian nations have killed millions of chickens to stop the virus, but with limited success so far.



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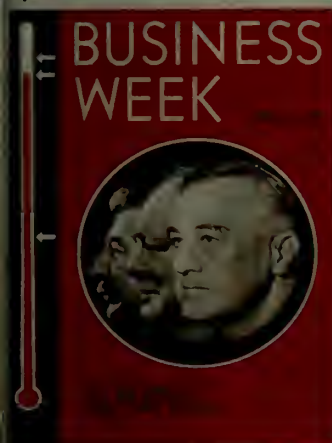
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75 YEARS IN COVERS

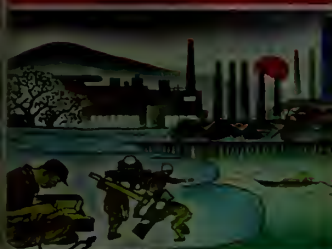
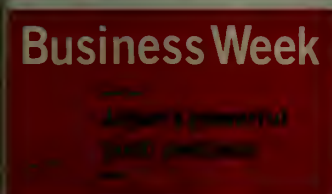
It began at a seminal moment—Sept. 7, 1929, a scant seven weeks before the great stock market crash and with a warning of “the inevitable adjustment that draws near.” But *BusinessWeek*’s cover design gave no explicit hint of what was inside. Early in the 1930s, however, the concept of the cover story took hold, and as the magazine tracked business—and the world—the cover began to mirror not just significant trends and events but also the evolution of design. Whether photography, illustration, or a skillful blend of graphics and language, covers trace the move from typewriters to computers and the Net, from the Depression to wars and the horrors of September 11, and corporate triumphs and foibles all along the way.



Sept. 7, 1929



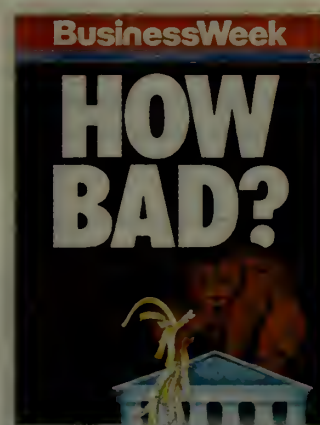
Feb. 17, 1945



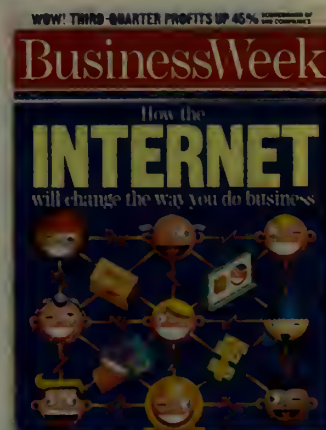
Aug. 19, 1967



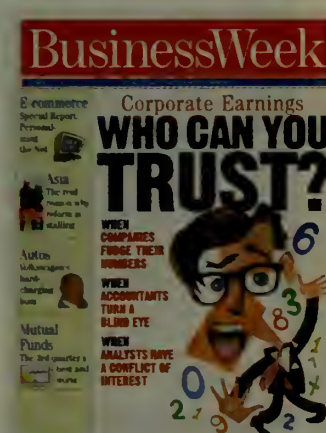
Nov. 24, 1975



Nov. 2, 1987



Nov. 14, 1994



Oct. 5, 1998



Sept. 24, 2001

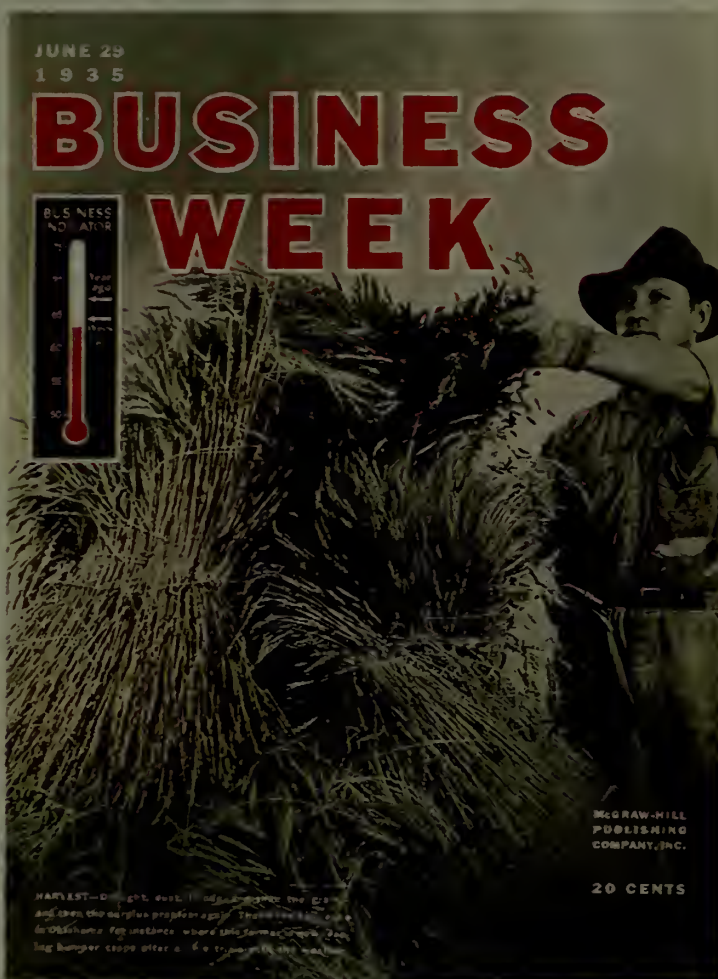
1930s The Depression—and Beyond

AS 1929 WANED, *BusinessWeek* looked ahead to a new decade, warning: "Business outlook—cloudy, continued cold."

The 1930s were a troubled time for executives caught between a search for ways to stimulate lagging business and the New Deal's unprecedented intervention in the economy. Government tried to step in with public works and a helping hand for farmers. War in Europe finally began bringing new

life to corporate order books. But labor pressures were rising and even bringing some industries to a halt.

The magazine was early in reporting on how to live with the new fair-trade laws, why and how to use the new art of public relations, the consumer movement, and industry in the Soviet Union. And a bright new business called television flashed onto the cover for the first time.



June 29, 1935 Bumper crops in Oklahoma make news, but the miseries of the Dust Bowl lie ahead. Life on the farm would never be the same as the work became increasingly mechanized and federal programs changed the economics of agriculture. A thermometer representing BW's index of the economy was a cover fixture until the early 1960s.



Dec. 18, 1929 The market crash left business clinging to hope—by its fingernails.



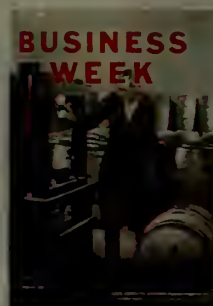
Mar. 15, 1933 As the sour jost goes, business is "on holiday along with the banks."



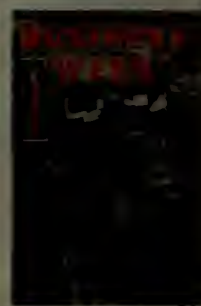
June 10, 1933 J.P. Morgan and son face Congress as Wall Street comes under fire.



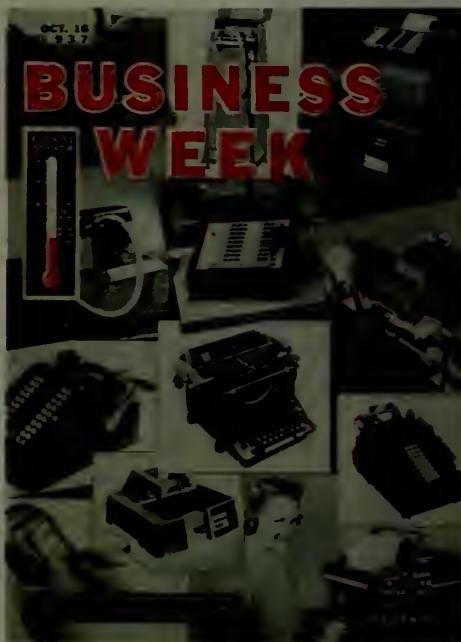
July 8, 1933 At the helm is Franklin D. Roosevelt, with economic adviser Norman Davis.



Nov. 18, 1933 With Prohibition repealed, the first barrel of "legal likker" gets weighed.



Apr. 7, 1934 In a sign of the times, GM rolls out lower-priced car, but strike threats loom.



Oct. 16, 1937 The latest in office equipment is on display to meet "the increasing need for more complete business records." Meanwhile, other covers greet air-conditioning and the first Pan Am Clippers to Asia.



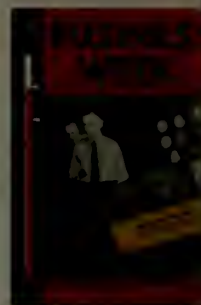
July 7, 1934 As BW "audits" of the New Deal begin, the cover is Treasury's Morgenthau.



Sept. 5, 1936 Boulder Dam (later renamed for Hoover) is part of a wave of public works.



July 24, 1937 China stands against Japan's force—the "open door" for trade is closing.



Dec. 31, 1938 TV is in its infancy, but BW tells executives that 1939 is "the television year."

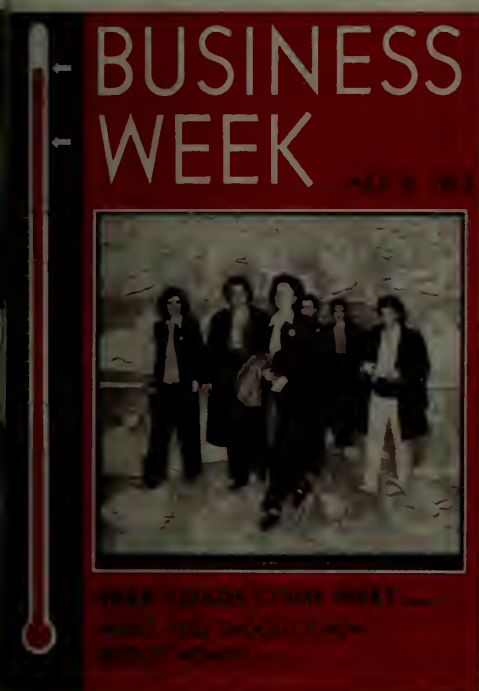
1940s War and a Troublesome Peace

THE EFFORT TO WIN WORLD WAR II—and the peace that followed—dominated the 1940s. Even before Pearl Harbor, the defense push brought new life to production but also new rules for doing business.

As early as 1943, there were covers on what to do when the war effort ended, and then on the shape of the postwar world: a new monetary system, the division of Germany, the

founding of the U.N., and what the Marshall Plan meant to executives.

On the home front, 1947 brought a series of reports on the new American market, region by region—markets that fueled an unprecedented postwar boom. P.S. Like most other seers, *BusinessWeek* was wrong about the 1948 election. The Oct. 23 issue had Dewey “all but installed” as President.



May 16, 1942 With men at war, women join the production line, and a survey shows they often do the job better. The workplace will never be the same, from Rosie the Riveter to the executive suite. Labor turns peaceful for the duration.



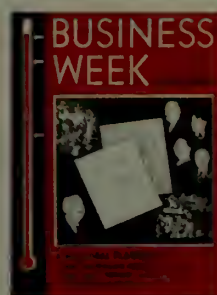
Dec. 14, 1940 Europe is already at war, so U.S. industries such as steel hum once more.



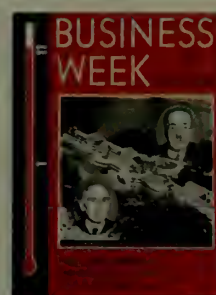
Oct. 28, 1944 Henry Ford and grandson Henry II plan a postwar car priced to beat Chevy.



Dec. 20, 1941 Only days after Pearl Harbor, troops guard a Boeing plant, and victory plans start early.



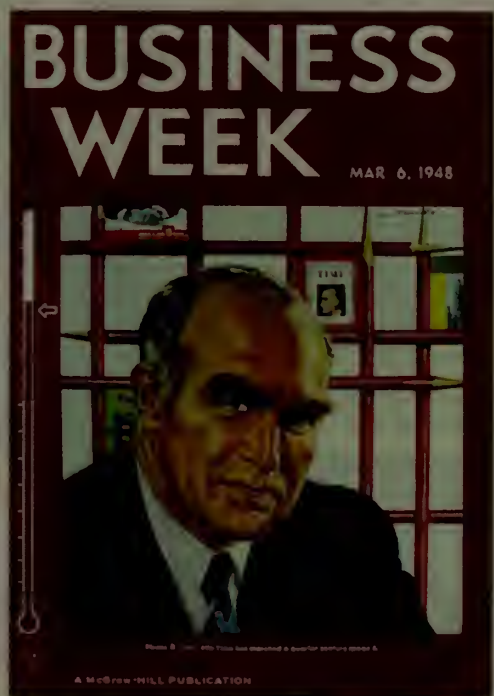
Mar. 20, 1943 War requires controls: The New Deal presents its “platform” for industry.



July 8, 1944 A new world monetary system forms at Bretton Woods—and Keynes (lower left) helps.



Oct. 1, 1949 Louis B. Mayer of MGM: Fledgling TV is already a worry for the Hollywood moguls.



Mar. 6, 1948 Henry Luce and his publishing empire mark the 25th year for *Time* magazine, from the outset an innovative venture. His *March of Time* newsreels were a precursor of the TV journalism that was in its infancy.



Feb. 17, 1945 Stalin, Churchill, and Roosevelt sketch a postwar map at the Yalta meeting as the war against Japan goes into its final months. But FDR's life is soon to end, and as the Soviet Union plants its foot firmly in Eastern Europe, Churchill sees an “iron curtain.” The Cold War is on—and the curtain won't lift for close to half a century.

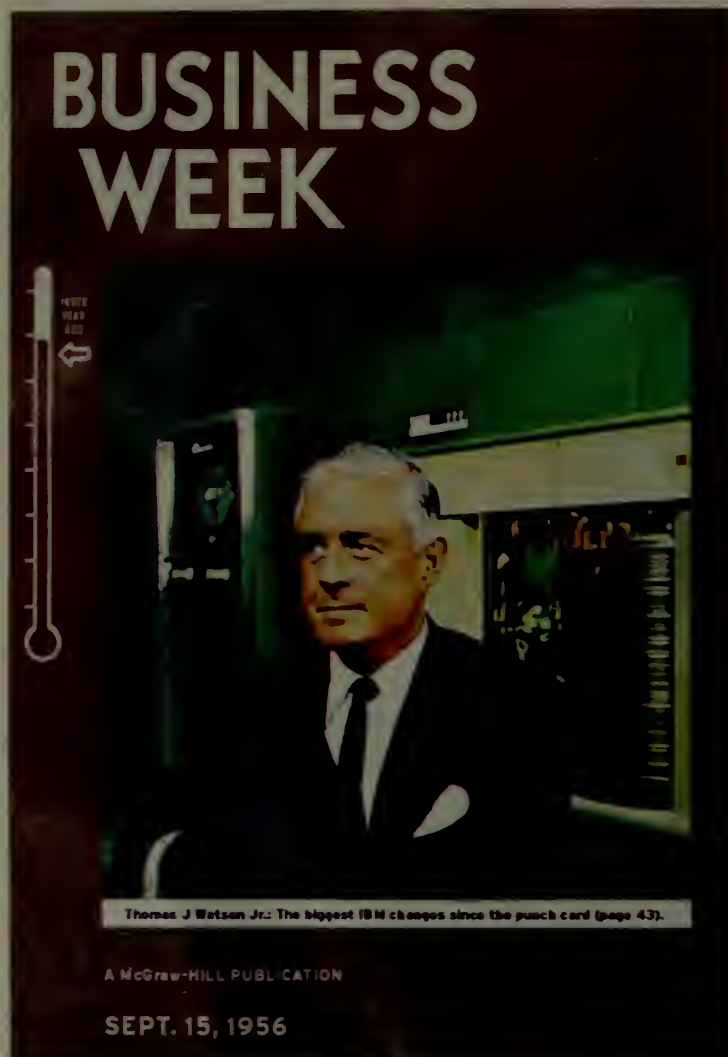
1950s The New Consumer

CONSUMERS RULED THE 1950s, and business was there to cater to them. But covers also caught some new trends still much in evidence. Two examples: the power of private pension-fund money and an already visible shortfall in Social Security.

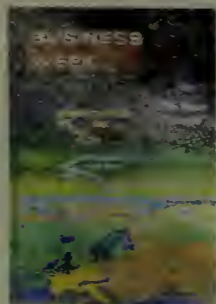
An executive-suite woman made her appearance (Hazel Bishop: "The lipstick business can't be kissed off"). As U.S. industry started to move south and west, communism was

building an industrial power in China, and Sputnik rocketed the world into the Space Age. In Detroit, the move to smaller cars began (preceded by the ill-fated Edsel). The decade also saw the birth of an entertainment icon (Disneyland) and of the European Common Market.

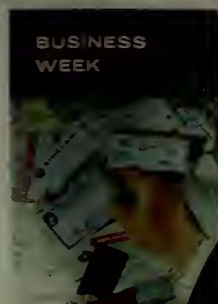
And a 1951 cover pointed out: "A lot of management theories are all wrong."



Sept. 15, 1956 Thomas J. Watson Jr. takes over from his father at IBM and fathers "the biggest IBM changes since the punch card"—the march into electronic data processing. But computers still fill rooms and are big-budget items, far from the consumer and most office desks. But as the new machines spread, a brainpower shortage emerges.



June 29, 1957 It's the dawn of the European Common Market—and of a new global era.



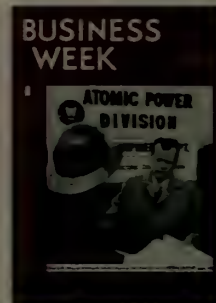
Aug. 18, 1958 The new American Express credit card gives a big boost to plastic. Charge it!



Sept. 19, 1959 Haloid Xerox' Joseph C. Wilson begins to invade the office-copying market.



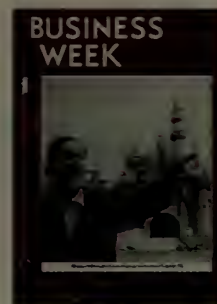
Nov. 17, 1951 RCA's David Sarnoff (right): An electronics pioneer wrestles with color TV.



Mar. 14, 1953 Hopes are high for the future as the atom goes to peaceful work at Westinghouse.



June 12, 1954 Instant photography! Edwin Land and his baby, the Polaroid camera.



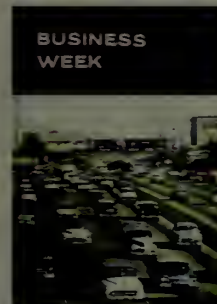
July 9, 1955 Walt Disney (father of "the mouse that turned to gold") readies Disneyland for opening.



Oct. 1, 1955 For all the talk about automation, business needs "the facts behind the word."



Mar. 10, 1956 BW report on "the long reach of TV" branded on the cover as cyclops.



May 18, 1957 "Los Angeles lives the future today" as a pattern other cities will follow.



Sept. 26, 1959 At Ford, Robert McNamara is a whiz kid. There's a Pentagon in his future.



Aug. 30, 1952 Jets are still on the way—though it won't be long—but airlines rev up for a big boom in travel. They will soon share with TV the fame (or blame) for blurring geographical and cultural differences.

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1960s Vietnam—and Civil Rights

PERHAPS THE BIGGEST NEWS for the future was the research revolution ("The U.S. invents a new way to grow").

Meantime, as U.S. companies went multinational, the war in Vietnam made Americans restless. So did the civil rights struggle, but some companies showed the way to peaceful integration of the workforce. Lyndon Johnson moved into the White House after the Kennedy assassination.

On a 1960 cover, older people already loomed as a new political and economic power. Computer software began to promise shortcuts, while computers became a huge world market ("Need info? Dial a computer," said a 1967 cover). And U.S. exporters found opportunities in the new Europe.

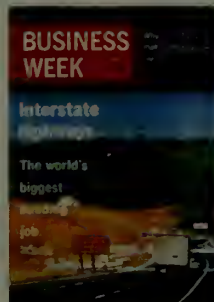
Airport congestion was worrying the new jet-setters—and for corporate women, it was still a difficult climb to the top.



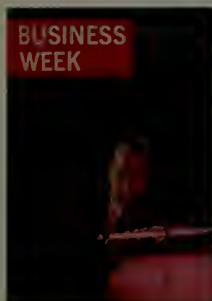
Mar. 26, 1960 The fastest-growing business is semiconductors, as electronics takes off.



Nov. 5, 1960 Plants get a new kind of boss: the computer, taking over many routine jobs.



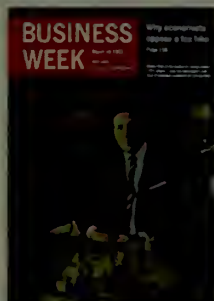
June 16, 1962 The world's biggest building job is the new web of interstate highways.



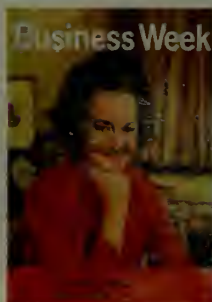
Aug. 18, 1962 Lasers become a wonder tool for the world, thanks to Charles Townes.



Jan. 9, 1965 AT&T's Frederick Kappel sees data transmission in the phone's future.



Mar. 18, 1967 James Ling and LTV exemplify a new kind of company: the conglomerate.



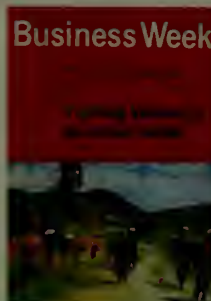
May 27, 1967 Katharine Graham, the power behind *The Washington Post*, builds an empire.



Nov. 3, 1962 After the Bay of Pigs fiasco, the face-off over Soviet missiles in Cuba ends with a victory for President Kennedy as Khrushchev backs down. But decades later, Cuba is still an outcast in the hemisphere.



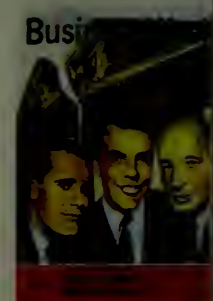
Aug. 19, 1967 Japan's export drive is making waves, and at the same time, many U.S. companies turn into multinationals and go worldwide to compete. The international focus during the 1960s also includes reports on Khrushchev's Russia, the role of U.S. business in the new Europe, and European consumers.



Sept. 23, 1967 Not just a bitterly contested war zone, South Vietnam is an economic disaster.



Apr. 13, 1968 After Martin Luther King Jr., the civil rights struggle goes into a new phase.



May 31, 1969 Go-go comes to Wall Street via upstarts Donaldson Lufkin & Jenrette.

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1970s Oil Woes, Debt Worries

THE STAGFLATION OF THE '70s spooked America. The impact of OPEC's oil embargo proved we were truly living in a global economy. Within the U.S. there were also worries about the massive overhang of debt, public and private. *BusinessWeek* labeled it "The Debt Economy"—and was already warning about a bias against saving.

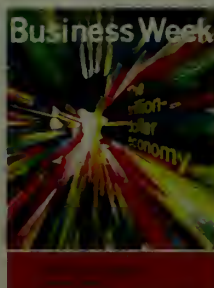
A takeover binge changed the structure of Corporate

America just as the trend toward conglomerates had done in the 1960s. And many managers had to start worrying about a cleaner environment.

The TV networks were shrugging off new competition (including cable), and as "information processing" became a buzzword that would revolutionize the workplace, the banking industry unveiled something called an ATM.



Aug. 22, 1977 As the space shuttle blasts off, U.S. industry sees a new frontier opening for it. Back on earth, the cost of health care raises anxiety, while the corporate board of directors is declared "obsolete unless overhauled."

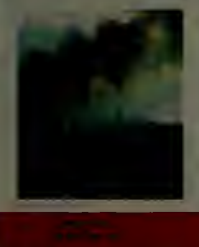


Oct. 17, 1970 The U.S. economy hits \$1 trillion. Forecast: A resurgence of power for the states.

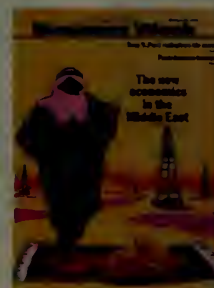


June 30, 1975 It is a "maddening struggle to survive" for small business. Sound familiar?

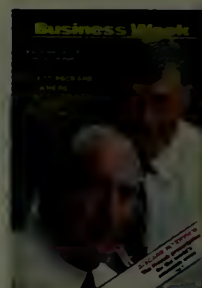
BusinessWeek



Feb. 6, 1971 Clean air and water are a national goal; Union Carbide learns the hard way.



Oct. 20, 1973 The Arab oil embargo jolts world economies as the Middle East flexes its muscle.



June 9, 1975 Hewlett and Packard (left) aim for premium products and don't haggle on price.



May 22, 1978 Deficit spending creates "The Great Government Inflation Machine."



Mar. 12, 1979 The Statue of Liberty weeps for "The Decline of U.S. Power," with defeats in Vietnam, setbacks in Iran and Afghanistan, a trade deficit that won't go away, and the continuing Cold War souring the nation's mood.



Why Robert Sarnoff quit at RCA

Interview: John Connally's economic remedies

Will there be anything left to sell at Levitt?

Nov. 24, 1975 Marion Kellogg of GE illustrates that for women, it's "up the ladder, finally." *BW's* Corporate Woman department chronicles progress toward shattering the glass ceiling (in earlier years the magazine for the most part was implicitly "Corporate Man"), just as the civil rights struggle had been spotlighted in the 1960s.

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By pioneering clean and efficient power generation, Siemens is helping to reshape and redefine tomorrow's energy. With our energy-efficient power communications, we're helping to make the world's energy systems more efficient and more secure. We're helping to make the world's energy systems more efficient and more secure. We're helping to make the world's energy systems more efficient and more secure.

SIEMENS

Global network of innovation

1980s High Hopes for High Tech

TOYOTA WAS IN THE FAST LANE, and so was high tech—Apple, Compaq, and Microsoft joined IBM as household names. Telecom was “everyone’s favorite growth business,” but a 1984 question was: “Did it make sense to break up AT&T?”

On the darker side, the stock market took a sickening dive. There was anxiety over America’s ability to compete and even about the quality of its human capital—and the goods it

produced. By 1983 the trade deficit with the rest of the world was our “hidden problem.”

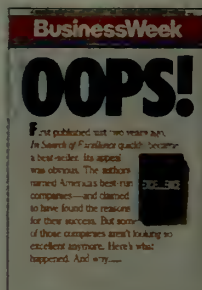
It was the era of Mike Milken, LBOs blazing—and of the executive as celebrity (remember Leona Helmsley?). Biotech generated new hopes. McDonald’s was building its own global McWorld. And perhaps the two most important words appeared on a 1985 cover: “Information Power.”



June 30, 1980 The call is for the U.S. economy to reindustrialize to meet world competition.



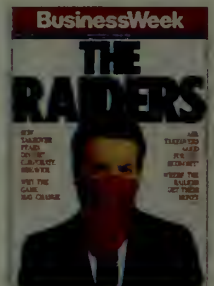
Oct. 27, 1980 “The hard-to-change values that spell success or failure”: corporate culture.



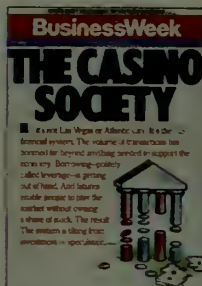
Nov. 5, 1984 Best-run companies? Maybe not the ones cited by *In Search of Excellence*.



Jan. 14, 1985 China is brewing its own brand of capitalism—and growing as a power in trade.



Mar. 4, 1985 Raiders stalk corporate targets and distort management behavior. Good or bad?



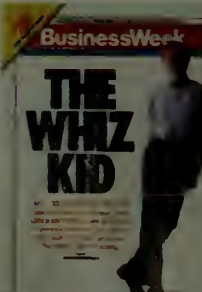
Sept. 16, 1985 “Casino Society” defines a system seemingly tilting too close to speculation.



July 7, 1987 What’s next after establishing power in global markets for both Japan’s exports and the yen? Prosperity and a new self-confidence feed a more international view, and new products keep flowing.



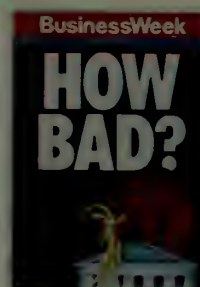
June 30, 1986 Tough Jack Welch sets out to transform GE—so far, so good is the verdict.



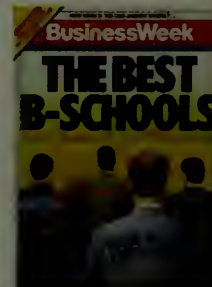
Apr. 13, 1987 Bill Gates at 31 had built Microsoft into a software power—and he was a New Age icon.



Sept. 21, 1987 Now anyone can be a Dick Tracy. Cell phones are here, if not yet ubiquitous—just wait a few years! Meantime, the Baby Bells were scrambling for their own identities after the spin-off from AT&T. And as computers kept getting faster, smaller and more powerful, the nature of jobs and work would never be quite the same.



Nov. 2, 1987 Another October crash—would the economy go, too? No, but it was quite a scare.



Nov. 28, 1988 The first of BW’s B-school surveys, still a must-read for MBA wannabes—and deans.



June 5, 1989 It’s the beginning of the end of the Cold War. Needed: A new kind of worldview.

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 WORLD'S FINEST WHISKY, YOU'D BE WORKING
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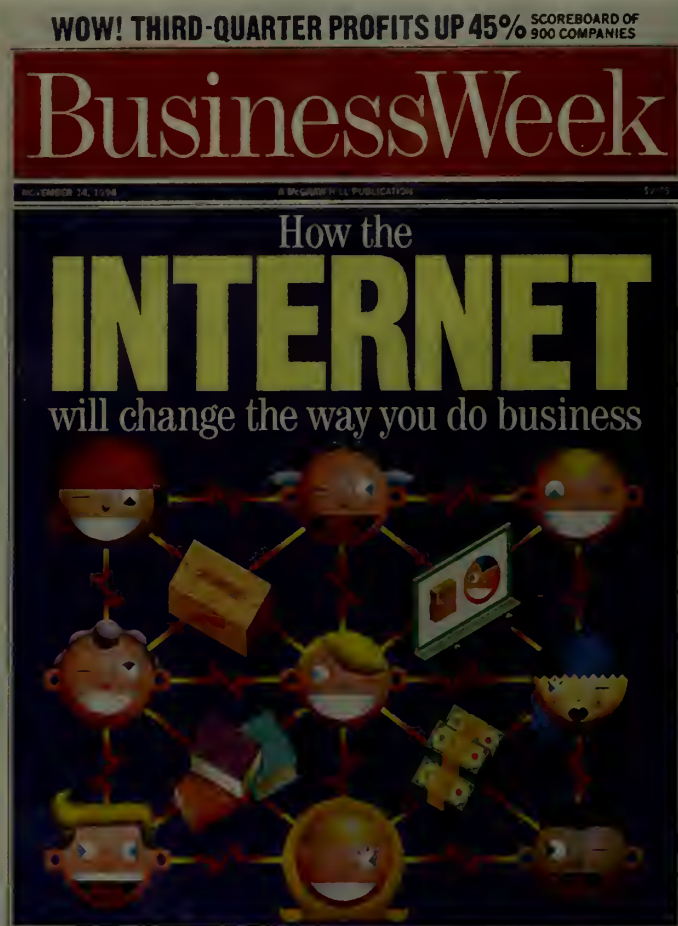
1990s Logging on to the Net

TIM KOOGL OF **YAHOO!** and Steve Case of AOL joined Bill Gates in the pantheon of wonder-boy executives as the Internet took wing. And Lou Gerstner at IBM breathed new life into an American classic.

Out in the marketplace, baby boomers had to move over as Generations X and Y appeared. Something called "virtual reality" made a cover bow in 1992, as did discount broker

Charles Schwab in 1994. "IPO capitalism" blossomed. But there was also scandal—mob influence on Wall Street and sexual harassment in high places (1996's "Abuse of Power").

NAFTA came on the scene, controversially, and so did hot money, racing around the world as globalization gained speed. Job security became an issue for many. And the cover question of the decade might have been: "Is Greed Good?"



Nov. 14, 1994 It's not too soon to declare that the Internet will change how America does business. Later into the '90s, there was a diagnosis of Internet anxiety, but the juggernaut was on an inexorable roll. "IPO capitalism" blossomed—nourished by adventurous Netpreneurs and high tech—but could it last?



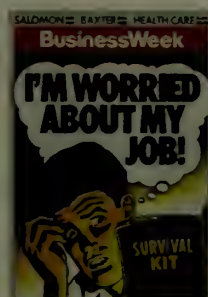
Mar. 31, 1997 It's a whole new kind of economy, fed by info tech. But what if high tech slows down?



July 14, 1997 If any one man dominates the new economy, it's Alan Greenspan at the Fed.



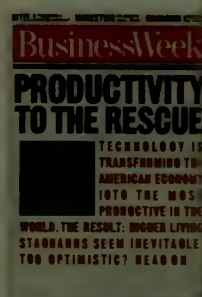
Jan. 26, 1998 Asian flu has the West sneezing—and fearing worse. What does the doctor order?



Oct. 7, 1991 Downsizing leads to new anxiety. An earlier question: Is corporate loyalty dead?



July 13, 1992 On the economic evidence, the waves of immigration are a help to the U.S.



Oct. 9, 1995 The boom in technology is making the U.S. the world's most productive economy.



June 3, 1996 Clearly, the public is in love with stocks—and the affair goes on. Will it ever cool?



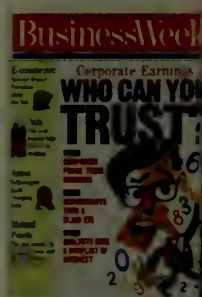
Dec. 16, 1996 Scandal hits Wall Street, neither for the first nor the last time. It will get worse.



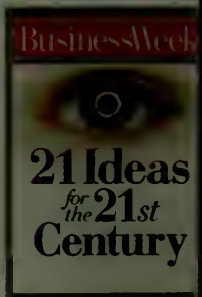
Mar. 24, 1997 A debut for the BW 50—looking the 50 best companies the S&P 500 index.



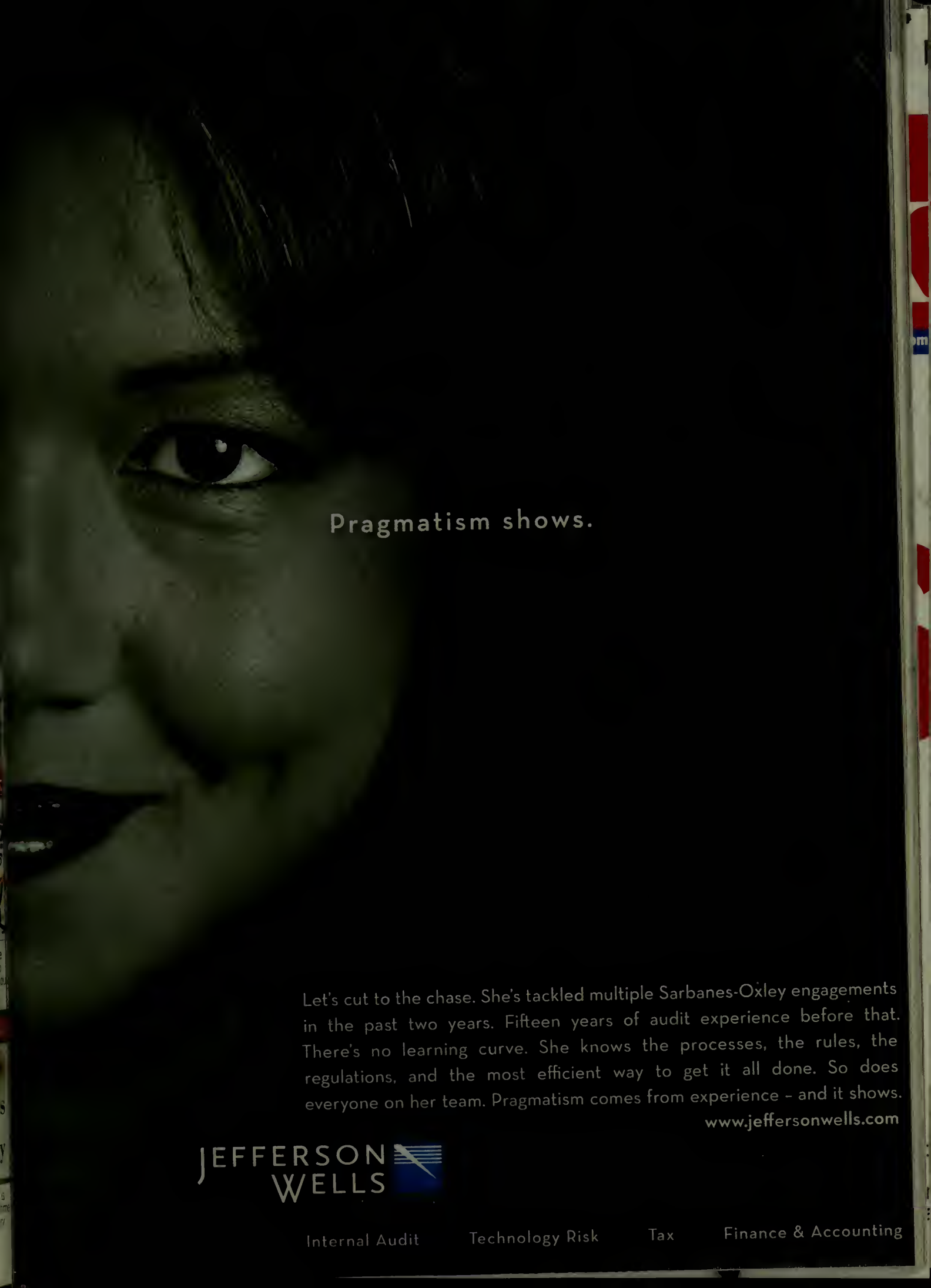
May 6, 1991 CEO pay, something BW started watching in 1952, is always a source of debate. The gap between the average worker and the executive suite is getting wider. Are boards of directors just a rubber stamp?



Oct. 5, 1998 Corporate auditors and blue-chip accounting firms turn out to be not so true-blue.



Aug. 23-30, 1999 It is almost 2000—and time to apply 20th century lessons to the 21st.



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Internal Audit

Technology Risk

Tax

Finance & Accounting

2000s The Shadow of September 11

WITH THE FIRST DECADE of the 21st century less than half over, there is no escape from the memory of September 11, 2001. But before that catastrophe, the tech boom had given way to a bust that infected the market and the whole economy. A cover in 2000 asked: "Wall Street: Is the Party Over?" By 2002 the question had changed to: "Wall Street: How Corrupt Is It?" On a less momentous scale, Martha Stewart's empire was

riding high, and so were giants such as Tyco and Enron—but stay tuned! At the personal level, one question was where job would come from—and whether workers could afford to retire. "I Can't Remember" announced a deep look into the mystery of Alzheimer's disease.

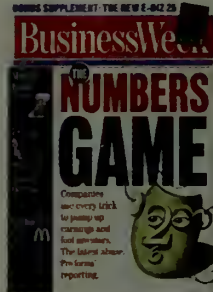
Americans continued to consume through ups and downs, but was the mass market an endangered species?



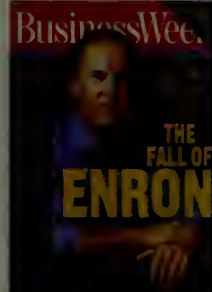
Feb. 21, 2000 The Net has a dark side: hackers who disrupt e-commerce as a prank or to steal.



Dec. 18, 2000 The glory days are over for tech highfliers. The worry: Will the economy crash, too?



May 14, 2001 Earnings are not what they seem, thanks to trickery such as "pro forma" reporting.



Dec. 17, 2001 Nothing symbolized the new scandals more than this thunderous collapse.



May 26, 2003 What? Boys are falling behind girls in education! What does it mean for society?



Oct. 6, 2003 The prices are great—but there are problems for workers, suppliers, communities.



Dec. 8, 2003 Brainpower fuels India's growth, and U.S. business feels it. Outsourcing, anyone?



Mar. 22, 2004 However good the recovery looks, job growth is a question that refuses to go away.



May 10, 2004 Industry after industry gets a new shape from the Internet. Which ones will be next?



DOES YOUR VOTE MATTER?

Only if you live in one of 17 competitive states. Or if you voted in an early primary. Or if your district wasn't gerrymandered to guarantee the incumbent's reelection. There's a lot wrong with the way America elects its leaders. Here's how to fix a broken system. **SPECIAL REPORT**

June 14, 2004 The votes of shockingly few Americans can tip an election. Is the Electoral College obsolete and ripe for extinction? And gerrymandering makes reelection to Congress almost a sure thing for many.



May 24, 2004 Research into stem cells and more holds great potential for the body to heal itself.



THE VANISHING MASS MARKET
New technology, product proliferation, fragmented media, fact reality: It's a whole new world.
July 12, 2004 Markets fragment, and companies rethink their messages and the media.



Sept. 24, 2001 The terrorists struck New York and Washington one day before this issue went to press. It was a shock to the nation likened to Pearl Harbor. The repercussions are still rolling, and many of the questions raised by 9/11 remain unanswered. But in all the magazine's 75 years, perhaps no other single event hit the fabric of society so hard.

Finally, a reason to buy technology again



Actually, make that 10 reasons to buy technology again. From their titanium finish to their 10-handset capability, Uniden's new PowerMax™ 5.8GHz cordless phones have it all. They're jam-packed with the latest features, like speakerphone, call waiting ID,



distinctive ring tones and a lot more. And, with 5.8 GHz of power inside, you'll get the kind of outstanding clarity and coverage others only wish they had.



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ON DEMAND BUSINESS

THE INNOVATION ECONOMY

New Ideas and Technologies That Are Changing the World

The Promise of Innovation 90

Why we could be on the cusp of a new era of dizzying transformation

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The Next Big Things in nanotech, energy, cars, anti-aging, and television

Global Hot Spots 162

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Managing for Innovation 192

Drawing inspiration from real-life corporate tales and the pages of science fiction

Voices of Innovation

Luminaries talk about venture capital, R&D, genomics, education, the Web, global warming, and more

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Napster is back. Over 700,000 songs strong. Students everywhere are downloading the music they want, when they want it, with just a click. IBM is helping university servers handle the demand. That's On Demand Business.



The new Acura 2005 RL automatically downloads diagnostic data, maintenance reminders and up-to-the-minute traffic conditions. IBM business consultants helped. Acura delivered. That's On Demand Business.

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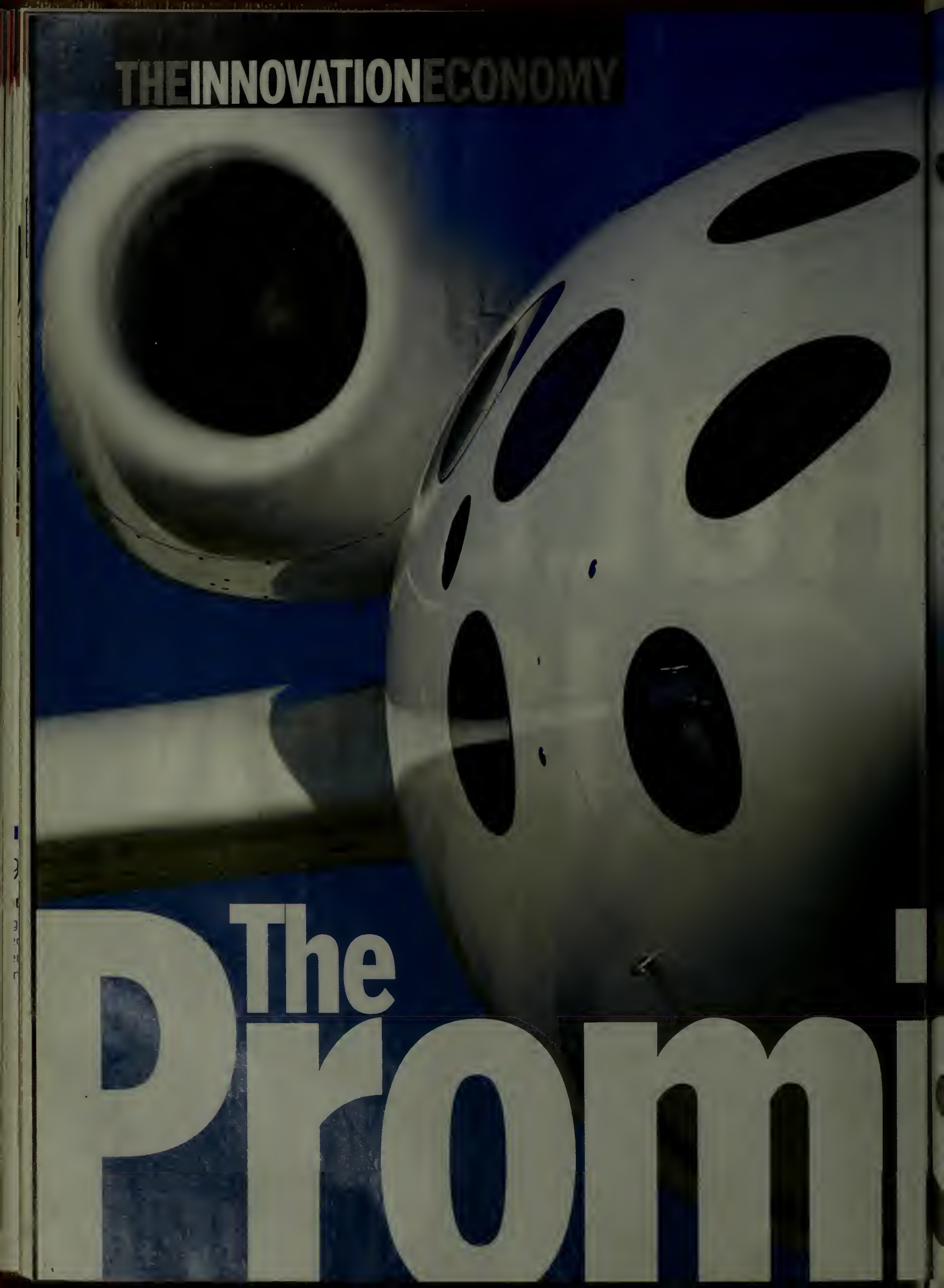
ROCK IS ON



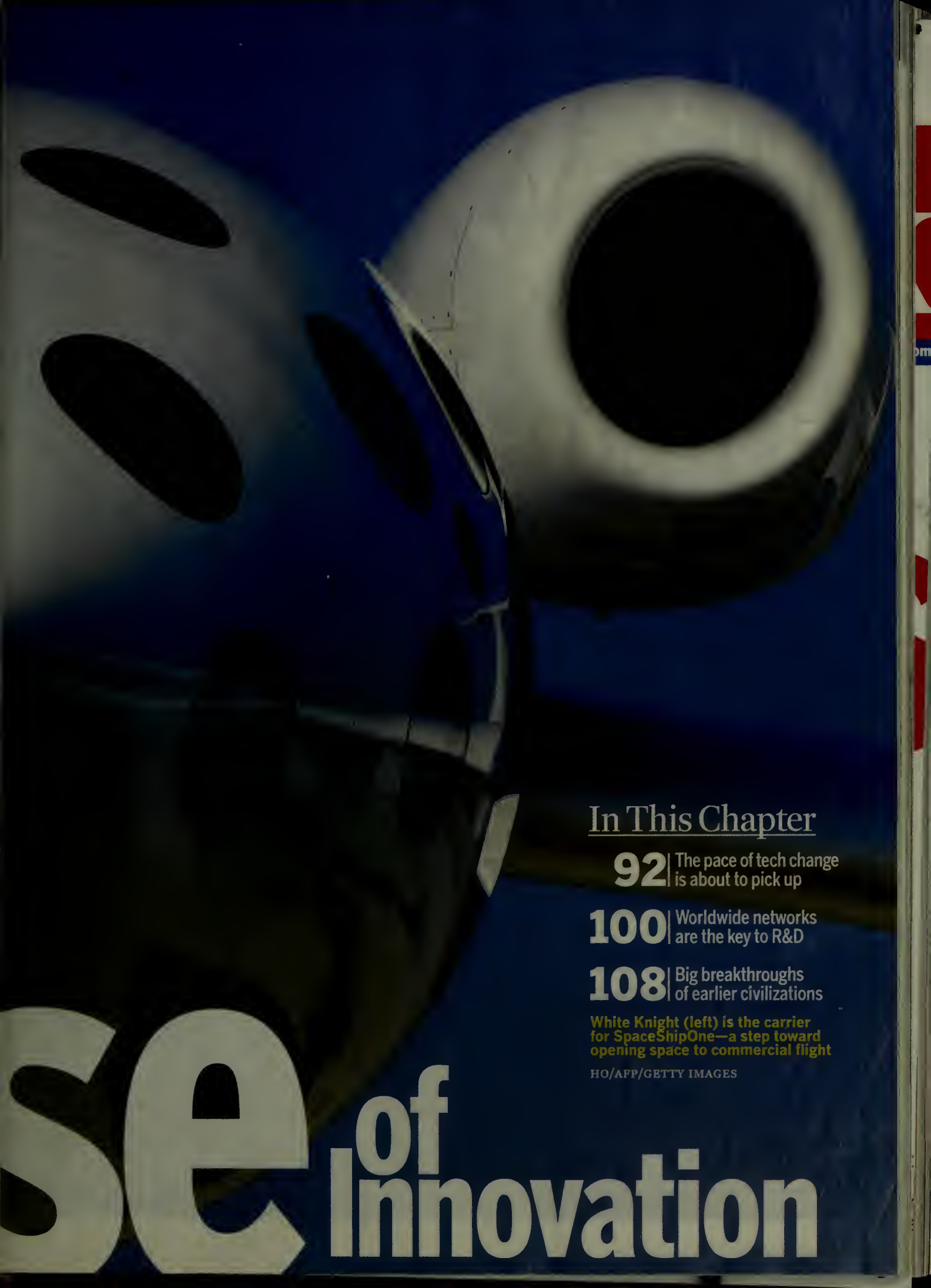
ROLL
ISON



THE INNOVATION ECONOMY



The Promise



se of Innovation

In This Chapter

92 | The pace of tech change is about to pick up

100 | Worldwide networks are the key to R&D

108 | Big breakthroughs of earlier civilizations

White Knight (left) is the carrier for SpaceShipOne—a step toward opening space to commercial flight

HO/AFP/GETTY IMAGES

This Way To the Future

From energy to biotech, we may be on the cusp of a new age of innovation. By Michael J. Mandel

SEVENTY-FIVE YEARS IS A MERE blink of history's eye. Yet since 1929, when *BusinessWeek* was first published, the world has been transformed by profound innovation and technological wizardry. Three-quarters of a century ago, there were no safe and effective antibiotics, no jet travel, no commercial television, and no computers. Many died of routine infections. A five-day ocean voyage was the main way to get from America to Europe, and "wireless" meant the wood-paneled Radiola in the parlor. Since then our mastery of the physical and biological world has strengthened remarkably. Life expectancy has soared, and most citizens of the planet can look forward to being around for 65 years or more. The Green Revolution has transformed agriculture, and the earth can now feed a global population that has tripled since 1929. We've left dusty bootprints on the moon, created the Internet, and learned how to read the human genome.

Thanks to these advances—and a string of others—workers are able to produce far more than they did in 1929. Output per hour in the U.S. has risen almost fivefold over the past 75 years, translating into an average climb of 2% a year in productivity. Many oth-



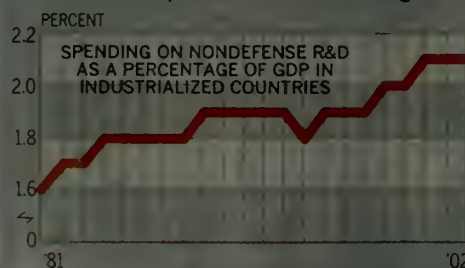
er industrialized countries have seen comparable gains, while developing countries have been able to take advantage of fast travel and a near-instantaneous web communication to become truly part of the global economy in a way that would not have been possible in the past.

But as we consider the state of the

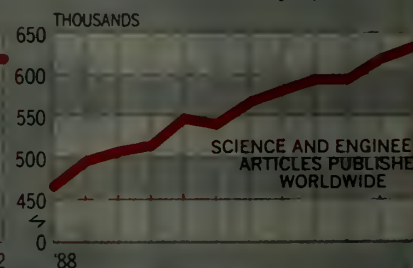
The Global Commitment

More resources around the world are flowing to R&D and higher education, ushering in the next wave of new products and new ideas

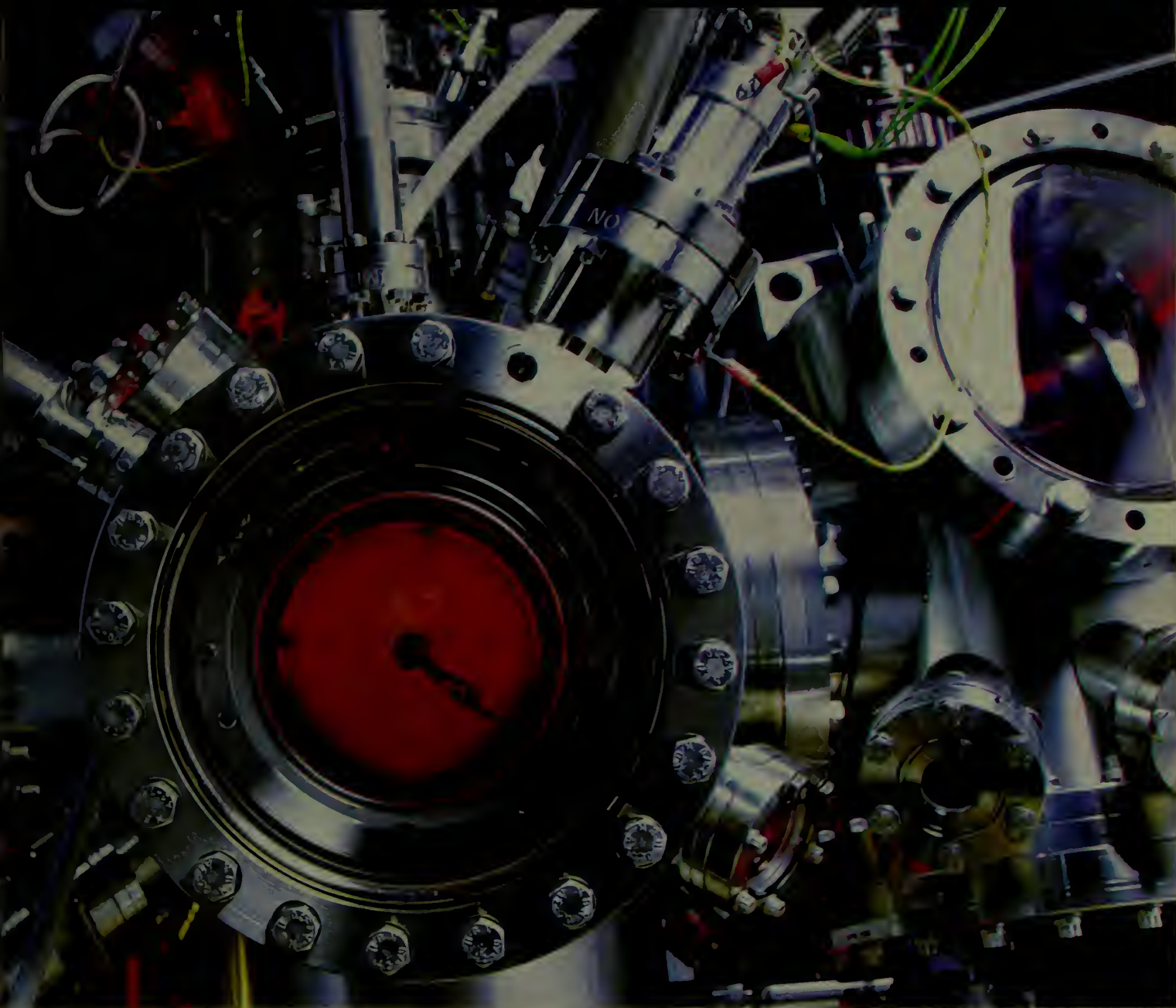
Spending on research and development has been rising...



...scientific publications are way up...



Data: National Science Foundation, Organization for Economic Cooperation and Development, ECD, BusinessWeek



novation Economy, it's clear that the march of technological progress has been uneven. In recent years, change has been far more rapid in information processing and health care than in energy, transportation, and manufacturing. In many industries we still depend on older technologies that date back to the 19th and

early 20th centuries. The internal combustion engine was invented in Germany in the 1860s, Thomas Edison's first commercial electric power station opened in 1882, and today's process for turning bauxite into aluminum was first demonstrated in 1886. To someone from 1929, today's cars and gasoline pumps would seem familiar in function, if different in details, while today's computers would be completely mysterious.

THE STAGE IS SET

SO A FAIR QUESTION to ask is this: Should we expect the next 75 years to bring the same sort of exciting and radical innovation that has transformed information technology and health care? Or will the progress be slower and more incremental—an elaboration of existing technologies and industries rather than the birthing of new ones? In short, where

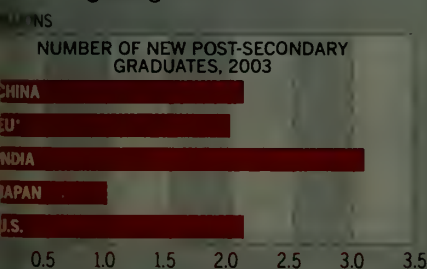
is the Innovation Economy heading?

Making predictions about technological change is always perilous. But, as we hope to show in this Special Report, the global economy could be on the cusp of an age of innovation equal to that of the past 75 years. All the right factors are in place: Science is advancing rapidly, more countries are willing to devote resources to research and development and education, and corporate managers, too, are convinced of the importance of embracing change.

Across the range of fields, from energy to biotech, and from software to autos, there are innovations brewing that could revolutionize our lives. In recent years scientists in different disciplines have been laying the foundations for nanotech, preparing the way for feats of en-

NANO SCOPE At HP, studying the shape of ultra-tiny things to come

...and the world's workforce is getting more educated



gineering at the scale of atoms and molecules. Such small wonders could eventually lead to vastly faster computing devices based on carbon nanotubes, miniature medical probes, and new types of lights and solar cells.

There are signs, too, that energy technology is about to make a dramatic leap forward, with the promise of efficient fuel cells, new approaches to solar power, and safer nuclear plants. Such advances have the potential, in the not-too-distant future, to overturn the economics of energy, making the world less dependent on oil and other fossil fuels.

And in the biological sciences, the current limits on health and mortality may turn out to be a boundary waiting to be traversed. "We are finding out how life works in such fundamental ways," says Susan L. Lindquist, director of the Whitehead Institute at Massachusetts Institute of Technology. "If we can leverage that to understand why things go wrong,

it will have an amazing impact." Adds Kevin W. Sharer, CEO of biotech giant Amgen Inc.: "I liken today to 1946, when the potential for computers and electronics was just emerging."

Not coincidentally, this new wave of technologies is gathering force just as innovation has gone global. In the industrial countries, non-defense private and government spending on R&D has risen from 1.6% of gross domestic product in 1981 to 2.1% in 2002, the last year for which data are available. Published scientific research has increased by 40% since 1988, with the gains spread around the world. And many countries in Europe and Asia are following the U.S. lead and devoting more money to higher education, which produces a key input for innovation—educated workers.

What's more, the leading engine for innovation—the U.S.—is still going strong. True, there's justifiable concern among top scientists and corporate leaders that the U.S. could eventually fall

behind its global rivals—a "quiet crisis" in the words of Shirley Ann Jackson, head of Rensselaer Polytechnic Institute and president of the American Association for the Advancement of Science. at least for now, "we still truly have best graduate programs in science engineering," says Jackson. "And have the kind of economic system capital markets that support the exploitation of technological innovation."

PRESSING NEEDS

THE RATE AND PATH of innovation be critical for determining the world's economic future. Indeed, having an innovative society may be more important growth than having a high rate of capital investment. Since 1995 the share of national output going to business investment in the U.S. has averaged only 11.3%, almost identical to the previous two decades, considerably lower than Japan. Yet productivity has surged because of the

Innovation Runs Hot and Cold

Where Change Has Been Explosive...

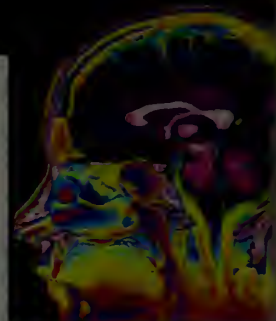
INFORMATION TECHNOLOGY

- ◆ Television
- ◆ Transistors
- ◆ Microprocessors
- ◆ Fiber optics and lasers
- ◆ Internet
- ◆ Cell phones

- ◆ Heart surgery and pacemakers
- ◆ Transplants
- ◆ Oral contraceptives
- ◆ Minimally invasive surgery
- ◆ Biotechnology

BUSINESS & FINANCE

- ◆ Lean manufacturing
- ◆ Supply-chain management
- ◆ Big-box retailing
- ◆ Mutual funds
- ◆ Financial derivatives (such as mortgage-backed securities)
- ◆ Venture capital
- ◆ Automated teller machines
- ◆ Credit cards



HEALTH CARE

- ◆ Antibiotics
- ◆ MRI and CT
- ◆ Antidepressants

... And Where It Has Been Slower

TRANSPORTATION

- ◆ Radial tires and automatic transmissions
- ◆ Containerized shipping
- ◆ Jet aircraft
- ◆ Radar
- ◆ Helicopters

ENERGY

- ◆ Natural gas-powered turbines
- ◆ Nuclear power
- ◆ Solar energy

MATERIALS & MANUFACTURED PRODUCTS

- ◆ Synthetic fibers (such as nylon)
- ◆ Fiber composites
- ◆ Photocopiers
- ◆ Instant photography
- ◆ Microwave ovens

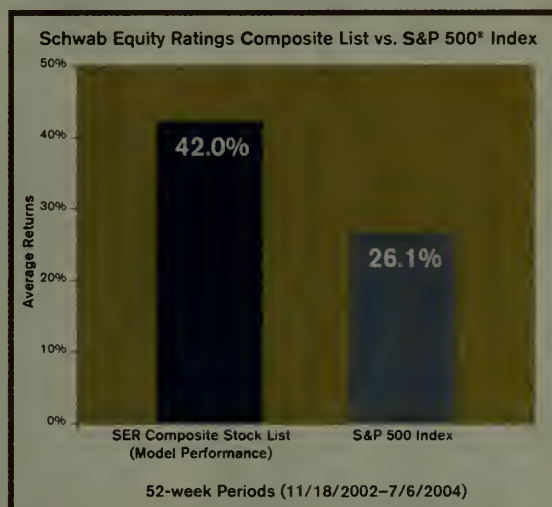


FREE AT LAST
A Motorola exec shows off in New York, 1973

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Steve Jobs



Chairman and CEO of Apple Computer and Pixar Animation Studios

“What can we learn from Apple’s struggle to innovate during the decade before your return in 1997?”

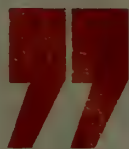
You need a very product-oriented culture. Apple had a monopoly on the graphical user interface for almost 10 years. How are monopolies lost? Some very good product people invent some very good products, and the company achieves a monopoly. [But] what’s the point of focusing on making the product even better when the only company you can take business from is yourself? So a different group of people starts to move up. And who usually ends up running the show? The sales guy. Then one day the monopoly expires, for whatever reason...but by then, the best product people have left or they are no longer listened to. And so the company goes through this tumultuous time, and it either survives or it doesn’t.

How do you systematize innovation?

You don’t. You hire good people who will challenge each other every day to make the best products possible. That’s why you don’t see any big posters on the walls around here, stating our mission statement. Our corporate culture is simple.

So the key is to have good people with a passion for excellence.

When I got back, Apple had forgotten who we were. Remember that “Think Different” ad campaign we ran? It was certainly for customers, but it was even more for Apple. That ad was to remind us of who our heroes are and who we are. Companies sometimes do forget. Fortunately, we woke up. And Apple is doing the best work in its history.



id adoption of new technology, in the form of the personal computer and the Internet.

Without technological breakthroughs, it will be difficult to solve the most pressing long-term problems. It’s hard to see, for example, how the fast-growing energy needs of emerging economies such as China and India can be met over the long term without new sources of energy. And providing affordable health care to aging populations around the world will be a challenge unless medical productivity dramatically improves—and that won’t happen until health-care technology advances far enough to reduce costs rather than increase them.

Nor will it be possible to generate enough good jobs for American workers in the future without new innovative industries. The events of the 1990s reminded us how a technological breakthrough—the Internet—could inspire an employment boom and create whole new categories of occupations, just as innovations such as the automobile and railroads have in the past. More than ever, it’s clear that America’s prosperity depends on its ability to remain the global innovation leader.

Innovations don’t have to be technological breakthroughs, like the Internet. They can be more mundane advances in, for example, manufacturing or retailing or the reorganization of work processes within a corporation. The idea of “lean manufacturing,” introduced by Toyota Motor Corp. in the 1960s and ’70s, showed how it was possible to increase the quality and reduce the cost of assembly-line production. Around the same time, the advent of “big box” retailers such as Wal-Mart Stores Inc., which opened its first store in 1962, brought highly efficient logistics and tightly integrated supply chains to retailing. This innovation—based in part on effective use of information technology—is a key reason why retail productivity has risen so much faster in the U.S. than in Europe. More recently, eBay’s ability to successfully run auctions online has opened up a

sales channel that never existed before.

In addition, the rapid pace of financial innovation—mostly in the U.S.—has made capital markets far more liquid and stable, translating into more innovation and growth. The first real venture-capital firm, American Research & Development, came into being in 1946, making it much easier to finance innovative startups. The invention of the credit card, introduced by Bank of America Corp. in 1958, gave middle-class Americans access to easy and immediate credit. And the creation of mortgage-backed securities markets in the 1970s transformed the way that home ownership was financed, and enabled home



HIGH ENERGY
Researchers work toward controlled fusion

owners to tap into their home equity.

But there are no guarantees, either for the global economy or for the U.S. It may take years or decades before scientific breakthroughs are translated into marketable technologies and products, equally long before businesses can figure out how to make the best use of them.

PITFALLS AHEAD

THE WHOLE PROCESS of innovation is far more delicate and fragile than many people realize. It requires a climate that funds basic research and encourages risk-taking yet has the market discipline necessary to identify the best products and bring them to market. “There’s nothing preordained about innovation,” says Joel Mokyr, president of the Economic History Assn. and a specialist in the history of technology. “There are 100 ways that this process could go wrong.”

And even if an innovation breakthrough occurs globally, the U.S. could still not get the full benefit. “What we have is special and needs to be nurtured and enhanced,” says Amgen’s Sharer. “Our comparative advantage could erode, and

A man in a dark suit and tie stands in the center of a long, brightly lit office hallway. He is holding leashes for three large, brown dogs that are walking towards the camera. The dogs are on leashes and appear to be pulling the man forward. The hallway has a high ceiling with recessed lights and a polished floor that reflects the light. The overall tone is serious and professional, contrasting the formal business setting with the unexpected presence of hunting dogs.

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we could end up looking like a Germany or Japan, where innovation can't get an economic return." There are plenty of pitfalls that need to be avoided. Government funding for R&D and for graduate science and engineering education could be squeezed by big budget deficits. Corporations may pull back on R&D if intense price competition makes it too hard to profitably capture the benefits of innovation.

Perhaps most worrisome, new terrorist attacks could engender even stronger security measures and increased military action worldwide. Terror, along with the security measures necessary to fight it, closes doors that should be open and impedes the free flow of ideas, goods, and people.

Such impediments would be a disaster since global innovation offers some of the best hope for breakthroughs in sectors where innovation has dragged. For example, the gasoline-powered internal combustion engine has long been the mainstay for the auto industry. Since 1929, there has been a lot of incremental progress, such as automatic transmissions and fuel-injected engines, but most motor vehicles still run on petroleum products, despite their environmental disadvantages and the need to import large quantities of oil. To shake this technological inertia, and move to new forms of propulsion—whether they are gas-electric hybrids, more efficient and less polluting diesels, or hydrogen-powered cars—will require the combined competitive efforts of U.S., European, and Asian auto makers.

More broadly, global R&D increases

» The pieces are in place for innovation, but the process is delicate. It needs nurturing in the form of freedom and funds

the odds of a revolution in energy generation and distribution, where the lack of change has been truly astonishing. In 1973, before the energy crisis of the 1970s, fossil fuels such as natural gas, gasoline, and coal accounted for 93% of all energy consumed in the U.S. Today, 30 years later, such "old technology" fuels still provide 86% of U.S. energy.

NO CRYSTAL BALL

EQUALLY IMPORTANT, nuclear power—one of the biggest technological advances, and supposedly the ultimate source of cheap power when it was introduced in the 1950s—turned out to be a bust. By the mid-'70s it was clear that nuclear power was far too expensive and too unsafe, and despite the high price of oil, U.S. utilities stopped ordering new nuclear plants after 1978. That was the high-water mark for energy innovation in the post-war era.

But the frontiers of energy technology have finally started to move forward again,

and it's a global effort. The leaders in solar power include Sharp from Japan and B as well as less well-known American companies such as Konarka Technologies and Nanosolar. Research in renewable energy such as wind power is done around the world. And even in nuclear power there are signs of change. China and South Africa are planning to test nuclear reactors of a new design that could be safer and more efficient, and researchers continue to explore nuclear fusion.

It's telling that the first issue of *BusinessWeek* includes a full-page advertisement from Pacific Gas & Electric Co. enticing manufacturers to the San Francisco area by offering them natural gas to power their factories, a technology that is still in use. By comparison, the ad in the same issue from International Business Machines shows off pictures of "accounting machines" that are antiquated today.

There's a lesson here. In 1929, no one could have predicted that IBM's "electronic sorting machines" would morph into today's lightning-fast computers. Today no one can predict the changes that might come over the next 75 years.

Ultimately, innovation is about continually pushing back the boundaries of what is possible. The true genius of capitalism is that it provides economic incentives for sustained innovation. Will the Information Revolution be followed by Biotech or Energy or Nano Revolution? No one knows. But with more and more smart people around the world working on new technologies—and the lure of riches if they succeed—the odds are looking better than ever. ■

The Future of Innovation

New Technologies

NANOTECH

◆ The ability to create new materials from "the bottom up" could transform health care, manufacturing, and computing (page 138)

ENERGY

◆ If energy prices stay high, new technologies may become economically viable faster than anyone expected (page 142)

BIOLOGY

◆ Biotech's economic impact may eventually equal that of the microchip, while advances in medicine could push the frontiers of longevity (page 148)

More Locations

SILICON VALLEY

◆ Still the leader in venture capital, the Valley's companies are working on combining info tech with biotech and nanotech (page 164)

ASIA

◆ Japan, long an R&D powerhouse, has been joined by such countries as India and China (pages 174 and 180)

EUROPE

◆ Despite relatively weak spending on R&D, European corporations remain strong in key tech areas such as mobile telephones (page 186)

A Commitment to Change

MANAGEMENT

◆ Even stodgy companies understand that they must encourage serial innovation and open up to new ideas from the outside (page 194)

GLOBAL SWEEP

◆ Utilizing the worldwide pool of knowledge and skills has become essential for the innovative company (page 201)

RESOURCES

◆ To stay competitive, countries will have to spend more to support R&D and graduate education in science and engineering (page 225)

Data: 



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China

BEIJING IS HOME to some of Microsoft's top computer graphics and synthetic-language whizzes. Among other products, their programs will appear in games played on Xbox consoles.

The lab also is doing cool things with speech—computer-generated voices that speak English in natural-sounding sentences, or a “visual audio notebook” that rapidly searches tape recordings for specific words.

This \$80 million center, with nearly 500 engineers, PhD students, and visiting professors, is one

of Microsoft's most important facilities for developing graphics, handwriting recognition, and voice-synthesis technologies. “One of the reasons we opened the Beijing lab was to tap into a great pool of talent,” says Microsoft Research Senior Vice-President Richard Rashid. Among the 72 innovations that have already ended up in Microsoft products is the “digital ink” used in software for tablet PCs. Others will eventually reach the market years down the road in everything from electronic-game players to industrial-design software.

THE FLOATING LAB

THE MICROSOFT LAB is much more than a showcase for how far China has come in computer technology. It also illustrates how innovation is an increasingly global game. It can involve a worldwide research and development operation like that of Microsoft, or IBM, which has major labs in China, Israel, Switzerland, Japan, and India. Or innovation can be the product of a much more amorphous structure: something that consultants call global innovation networks. These often consist of in-house engineers, contract designers and manufacturers, university scientists and dozens of technology suppliers big and small—all pulled together ad-hoc for a particular product.

To many Americans, who assume the

Scouring The Planet for Brainiacs

Worldwide innovation networks are the new keys to R&D vitality—and competitiveness. By Pete Engardio

STEP INSIDE THE LABS OF Microsoft's advanced technology Center outside Beijing for a lesson in 21st century innovation. In one lab, engineers have developed a program that simulates the movement of water around a tropical island, adjusting the lighting of the waves as they ripple over the reflection of a school of carp swimming at different depths. Technicians load a photo of a face into another program and the expression changes from a grin to a pout, down to the wrinkles on the cheeks and forehead. The



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every engineer hired abroad by Microsoft, General Electric, Intel, or Boeing means one less high-paying job at home, this is a threatening trend. There's also growing angst that the rapid advance of Chinese, Indian, and Russian science is imperiling U.S. global economic leadership.

But such fears often are based on an outdated view of global competitiveness. Because technology now crosses borders faster than ever—thanks to the Internet, cheap telecom links, and advances in interactive-design software—the location of R&D facilities matters less and less. What matters is who controls these networks—and where the benefits accrue in terms of products, jobs, new companies, corporate profits, and higher economic productivity. “The real challenge is to commercialize technology,” says Boston Consulting Group Executive Vice-President James P. Andrew. “Increasingly, that means integrating outside technologies and orchestrating global value chains.”

BOOSTING THE R&D BANG

THE 2000 TECH BUST and subsequent recession also have spurred companies to look at ways to get products to market faster. “There is tremendous pressure on industry to innovate more—and do it more quickly,” says Krishna Nathan, director of IBM’s 200-engineer Zurich Research Laboratory. The problem is, many companies also are finding their R&D efforts aren’t producing enough bang for the buck. In a

Boston Consulting survey of 250 senior executives, nearly seven out of ten cited innovation as a top priority and said they plan to hike R&D spending. Yet 57% also said they aren’t satisfied with the return on their innovation investments. A Forrester Research Inc. study found similar frustration. “CEOs feel they are throwing money into a hole, but little comes out,” says Forrester Vice-President Navi Radjou.

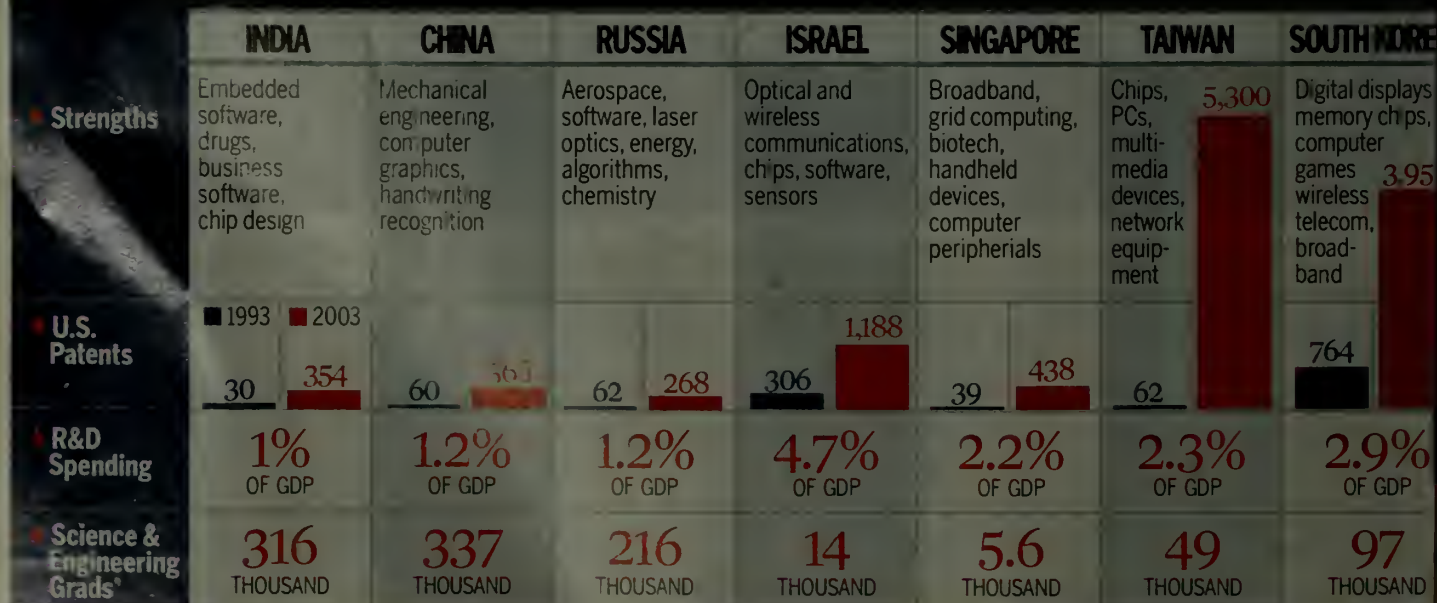
Korea

SOME OF THE WORLD’S most advanced digital displays now come from Korean makers like Boe Hydis. Images on its panel for the new M1400 tablet PC by Motion Computing are legible when viewed sideways and in daylight

Thanks to the burst of global R&D, innovative companies can now shop the world for intellectual property needed for new products. Cities such as Bangalore, Tel Aviv, and Seoul are starting to flourish Silicon Valley-like tech cl

The World’s Rising Innovation Hot Spots

In 2003, U.S. inventors secured 88,000 U.S. patents. The U.S. spent 2.7% of GDP on R&D and graduated 400,000 scientists and engineers. But developing nations are making rapid progress.



*degrees or higher

Data: OECD, National Science Foundation, and CHI Research

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ters nurtured by venture capital, tie-ups between science universities and industry, and a critical mass of inventors and entrepreneurs adept at selling their intellectual property worldwide.

South Korea, for example, is a trailblazer in next-generation digital displays, memory devices, wireless telecom, and electronic gaming. In Taiwan, long known for churning out me-too electronics products, R&D spending has leapt fourfold, to \$7.5 billion, since 1990. The island now boasts some of the world's most profitable chip and hardware designers. "Taiwanese companies used to be able to focus on low-end products and survive," says spokesman David Chen of Novatek Microelectronics Corp., a leader in chips for liquid-crystal displays used in high-end TVs, notebook PCs, and digital cameras that earned \$98 million on \$333 million in sales in 2003. "Now intellectual property is a serious matter."

A U.N. OF SUPPLIERS

TO GET AN IDEA of how diffuse the innovation process has become, try dissecting your new PDA, digital cameraphone, notebook PC, or cable set-top box. You will probably find a virtual U.N. of intellectual-property suppliers. The central processor may have come from Texas Instruments or Intel, and the operating system from BlackBerry, Symbian, or Microsoft. The circuit board may have been designed by Chinese engineers. The dozens of specialty chips and blocks of embedded software responsible for the

dazzling video or crystal-clear audio may have come from chip designers in Taiwan, Austria, Ireland, or India.

The color display likely came from South Korea, the high-grade lens from Japan or Germany. The cellular links may be of Nordic or French origin. If the device has Bluetooth technology, which lets digital appliances talk to each other, it may have been licensed from IXI Mobile Inc., one of dozens of Israeli wireless-telecom companies spun off from the defense industry. IXI has developed a package of software allowing users to wirelessly zap images, audio, and data from digital cameras to e-mail accounts to PCs. Among the products using IXI's package is ATT Wireless' new Ogo device for instant messaging.

India

TECHNOLOGY for decompressing digital video and music by ITTIAM, a hot startup in Bangalore, is inside such gadgets as this movie player for airline passengers by APS, now used by Ryanair



This spreading out of R&D is a boon innovation. By mobilizing global R&D teams around the clock, nimble companies can accelerate development cycles, bringing new technologies to consumers and industry faster, cheaper, and in more varieties. Multinationals can reach deep into once-cloistered university labs in Shanghai or Moscow for help in advancing everything from genetics and molecular research to alternative energy. Besides employing several thousand in India, France, Germany, and the U.S. to develop chips and software, Texas Instruments maintains brains at 100 info-tech companies from Berlin to Bangalore. This has been vital in maintaining TI's dominance in the \$5 billion global market for digital-signal processors for cell phones and consumer electronics. "The more we can leverage outside talent and companies with good ideas, the more product we can get on the market," says Doug Raser, who oversees TI's global strategic marketing.

Just as important, the global innovation supermarket lowers entry barriers for

» By mobilizing scattered R&D teams, outfits can speed development cycles, bringing new technologies to market sooner

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Cherry Murray



Senior vice-president of physical sciences research and a veteran at Lucent Technologies' Bell Labs

“How has the corporate lab system changed during the past 20 years?”

Large companies have become global and are no longer only focused on one market. Also, research and development around the globe was not possible when communication was only directly from person to person. The pace of R&D has gone up dramatically [with the advent of] the Internet. For example, in the '80s, we had a research prototype: It took about seven years of development before we put out a product. Today R&D occur simultaneously. There's no opportunity anymore to do research first and develop the technology gradually.

Are companies increasingly doing more research overseas?

It depends. Every large corporation is a global corporation with global markets and customers. The real reason for going global with R&D is twofold: first, to connect with your customers; second, to make sure you're getting the world's best talent—and the world's best talent doesn't necessarily come to the U.S.

What are the most promising areas of long-term innovation?

One is nanotechnology. We are just on the verge of being able to create materials and devices that don't exist in nature but are modeled on biological principles. I'm running a conference on [another innovation which] will take 20 years to develop. [The conference is] on the things that are at the intersection of biology and physical machines. These will be important for medicine and, of course, society. And there are things [in the works] like very broadband wireless pervasive networks.

dynamic new players. A good example of the new breed of technology networker is Austin (Tex.)-based Motion Computing Inc. With just 110 employees, Motion is the No. 3 seller of slate style tablet PCs, a market that research firm IDC predicts will near \$7 billion in three years. Motion shipped 25,000 of the \$2,000 machines last year, mainly to health-care and financial-service companies in the U.S. and 14 other nations. Motion's latest M1400 PC, which allows users to write directly on the screen, display articles as they appear in a magazine, and transmit documents wirelessly, is loaded with cutting-edge applications sourced from outside suppliers. The digital pen comes from Japan's Wacom Co. and the software for digital sketches from Toronto's Alias Systems Corp. The 12-inch pen-based screen, which can be viewed in bright sunlight and while tilted at a 160-degree angle, was developed by Korea's Boe Hydis, the world's leading supplier of tablet PC displays. The machines are made in China by Taiwanese contract manufacturer Compal Electronics Inc. “This business model lets us bring core technologies from around the world to market faster than our competitors,” says CEO Scott Eckert.

The digital convergence has sped the global tech scramble, because it means that many of today's gadgets now need to incorporate video, telecom, imaging, computing, and audio. “Very few companies can afford to invest the time and effort to stay at the forefront of so many technologies,” says Srinji Rajam, chairman and CEO of Bangalore-based ITTIAM Systems. “By licensing our design innovations, they can cut the time it takes to launch a product by nine to 12 months.”

Founded in 2001 by seven veteran Texas Instruments executives, the 125-engineer company has found growing demand for its embedded software and systems designs for decoding highly compressed audio and video content on the MPEG4 format. ITTIAM's 50 clients in the U.S., Europe, and Asia have used its designs in everything from a hand-size \$199 camcorder to a “digital-media album” that can store up to 130 hours of video and thousands of songs.

One customer is e.Digital Corp. The San Diego outfit develops multimedia appliances such as the digEplayer, a portable in-flight entertainment system used by 11 carriers, including Ryanair, Alaska Air Group Inc., and Hawaiian Airlines Inc. The machine, sold by Tacoma (Wash.)-based APS Inc., stores up to 30 highly compressed movies. Economy passengers rent the player for around \$10 to watch what and when they please.

“We're constantly scouring the world high-performance technologies that already out there,” says e.Digital Sen Vice-President Robert Putman.

'YOU HAVE TO BE TIRELESS'

INDEED, THE CHALLENGE is to keep with the ever-quicken pace of innovation. Design houses such as San Francisco-based IDEO are specialists at just that. The firm collects data on thousands of chip, software, and manufacturing out in more than 100 nations via trade shows, Web sites, and word of mouth—information that can speed product development. “You have to be tireless about updating these databases because the half-life of most of the information is about four weeks,” says Dave Blakeslee, leader of IDEO's smart-products unit.

Last year, IDEO was hired to develop a device to show patients what their smile

» Digital convergence has sped the global scramble as more gadgets call for video, telecom, audio, imaging, and computing

would look like after a tooth-whitening process by Walnut Creek (Calif.)-based BriteSmile Inc. It found the digital image compression algorithm from a Vancouver, B.C., company and an outfit in Ahmedabad, India, that specializes in making such algorithms work on TI's DSP chips.

Such blending of technologies will come even more common as innovation networks extend their reach. Many corporations have been obsessed with improving quality in the 1980s, boosting productivity in the 1990s, and slashing costs in the wake of the 2000 tech bust. Now, companies are zeroing in on how to innovate more efficiently. “The fallacy of innovation was that it was all about spending on R&D or information technology,” says Diana Farrell, director of the McKinsey Global Institute. “Instead, it has more to do with execution and getting products out better and faster. The answers are out there, waiting for the quickest and smartest to find them. ■

—With Dexter Roberts in Beijing
Neal Sandler in Tel Aviv
and Matt Kovac in Taiwan

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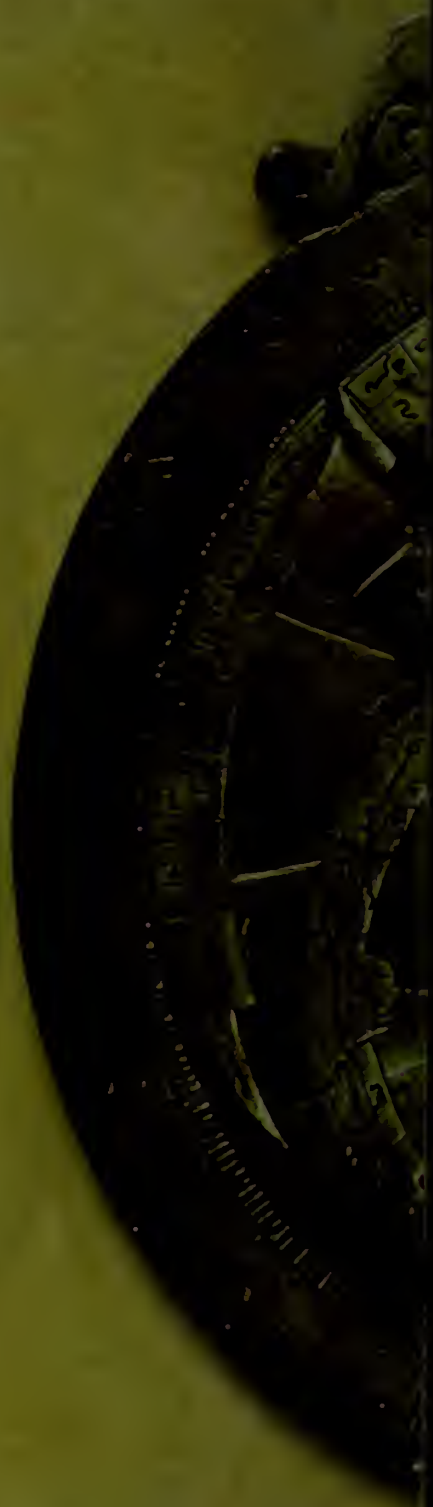
Birth Of A

By Hardy Green

All innovators stand on the shoulders of their forebears. Historians look much further back in time to discover the antecedents of trends or ideas and the true mothers of invention. We now understand that the Chinese developed movable type in 1041, long before Johannes Gutenberg; that the shipbuilding skills and navigational insights of Indians, Filipinos, Javanese, and Arabs were essential to Europe's Age of Discovery; and that South America's Quechua Indians vulcanized rubber two centuries prior to Charles Goodyear. Author Dick Teresi chronicles these and other developments in *Lost Discoveries: The Ancient Roots of Modern Science—from the Babylonians to the Maya*.

There's little question that many centers of invention, adaptation, cross-fertilization, and preservation have existed over the ages. Although the examples that follow are hardly comprehensive, they are a few noteworthy stopovers on the road to innovation.

Hammurabi, right; cuneiform tablet, below



» SUMER 3500 B.C.-1775 B.C.

This Tigris-Euphrates valley culture invented a form of writing and the wheel around 3500 B.C. Its people made cloth from wool and flax, built canals, observed the movement of planets, and worked out standard weights and measurements. Advances in math included quadratic equations and multiplication. Conquered by the Akkadians, the merged peoples formed the First Babylonian Empire, whose King Hammurabi (1750 B.C.) fashioned the law code that bears his name.

Notion



It's about time:
An Arabic brass
astrolabe,
circa 1295

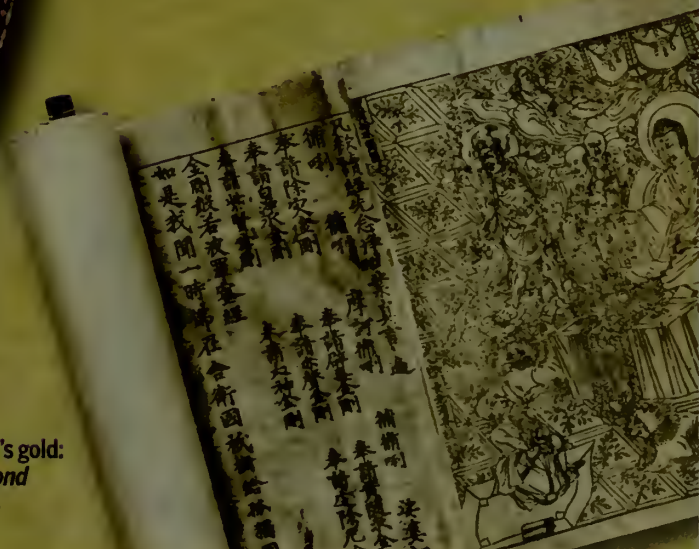
» MEDIEVAL ISLAM 750-1200 A.D.

Preserving and building on advances from Greece, Rome, and India—including philosophy, geology, engineering, hydraulics, and navigation—Muslim scholars were pioneers in astronomy and mathematics, including geometry, algebra, and trigonometry. They employed calendars and numerous timekeeping devices, including sundials, quadrants, astrolabes (invented by the Greeks), and compasses. They erected observatories at Baghdad, Damascus, and Maragha in Persia. Enhancements of Ptolemy's model of planetary motion prefigured Copernicus.

» T'ANG DYNASTY CHINA 618-906 A.D.

Chinese writing had existed as early as 1300 B.C. and paper since 150 B.C. In the fifth century A.D., Chinese began to make steel. The T'ang period saw the invention of the earliest mechanical clock, the stern rudder, gunpowder, and block printing, with the first completely printed book being *The Diamond Sutra* (868 A.D.). China's Middle Ages witnessed further improvements in compasses and the first understanding of magnetic declination.

Bibliophile's gold:
*The Diamond
Sutra*, 868





» MAYAN CULTURE circa 250-900 A.D.

The Maya built over 200 elaborate ceremonial cities—from Tikal in Guatemala to Palenque in Mexico—marked by limestone temple-pyramids, observatories, ball courts, and palaces. Causeways and earthen roads linked various sites. Their mathematical feats rivaled those of the Babylonians, and they produced an accurate solar calendar.

Pyramid in the ruined city of Tikal, Guatemala; a figure from a painted book, right

Beautiful painted books featured a hieroglyphic form of writing. Mesoamericans also excelled in plant breeding and astronomy.



» RENAISSANCE EUROPE

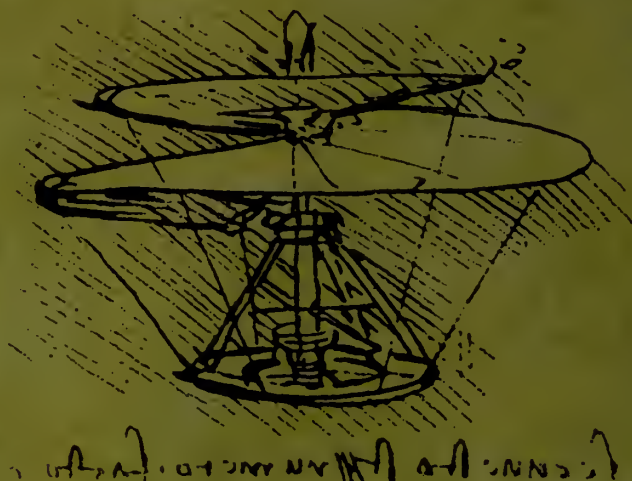
1300-1550 A.D.

In addition to a burst of artistic creativity, this period saw a new curiosity and spirit of invention in all fields, from commerce to science. Merchant banking appeared in Italy, anatomist Andreas Vesalius forced a debate with the church over human dissection, and Nicolaus Copernicus' *On the Revolutions of the Celestial Spheres* challenged the idea that the planets revolved around the Earth.

In the 1500s, artist and scientist Leonardo da Vinci dreamed up an array of fantastic inventions, from the horizontal water wheel to flying machines and a power loom. In the mid-1500s in Belgium, Gerardus Mercator emerged as a leading

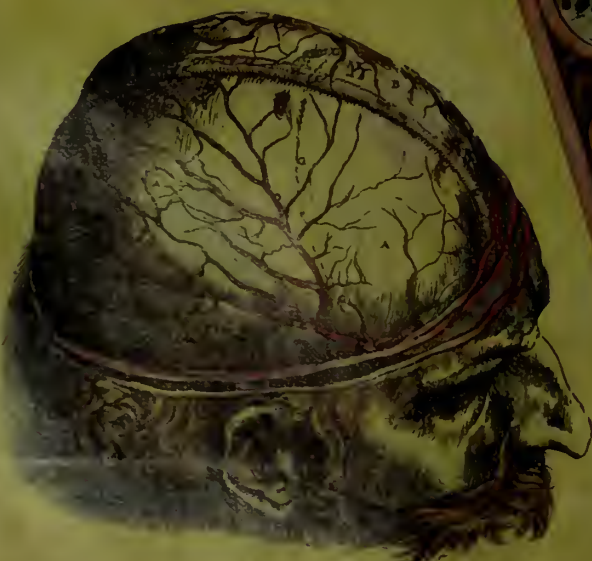
Woodcut from Vesalius' *De Humani Corporis Fabrica*, 1543

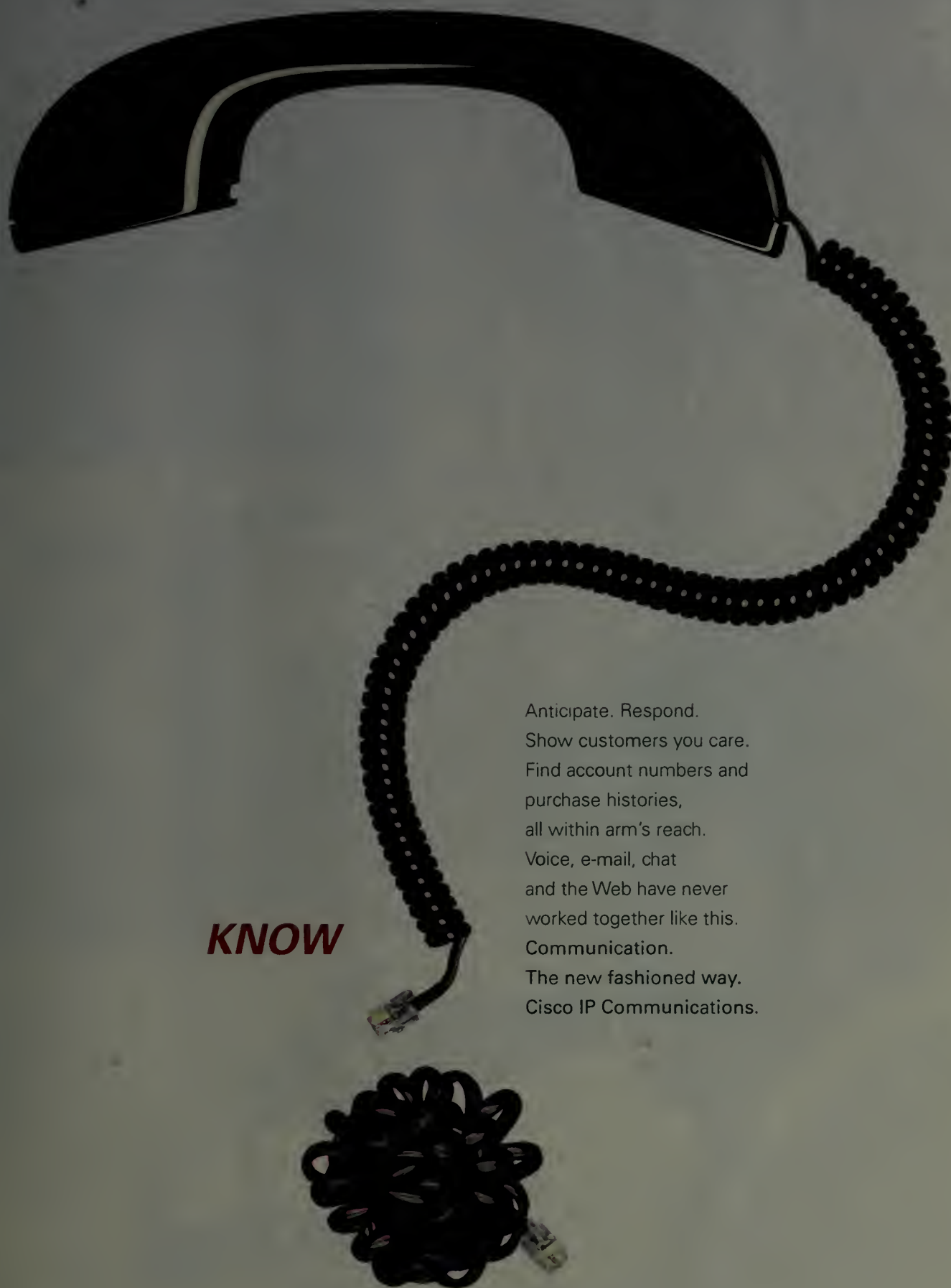
mapmaker, producing wall maps and globes for navigation.



Leonardo Da Vinci's sketch for a helicopter, 1483

Gerardus Mercator's map of the Arctic, 1595





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» THE INDUSTRIAL REVOLUTION 1750-1929

The Euro-American Industrial Revolution saw the application of water, steam, and electrical power to the production process, followed by a stream of new inventions. Among the innovations were James Watt's 1769 improved steam engine, the factory production system of the 1780s, and Eli Whitney's 1793 cotton gin, which in making plantation agriculture more profitable also strengthened an archaic economic institution, slavery. Other achievements included interchangeable parts, the steam locomotive and steamboat, the modern suspension bridge, the electric generator, photography, oil drilling, barbed wire, the telephone, and the incandescent lamp. Neither catastrophic wars nor natural calamities could stem the progress of technology in the 19th and 20th centuries: The culmination of the marriage of industry and technology may have been the emergence of the assembly line, most fully realized by Henry Ford around 1913. Historians differ over just when the era ended—perhaps with the beginning of the new century or as late as the onset of the Great Depression.



Forward motion:
Henry Ford's
assembly line at
Dearborn, top;
James Watt's first
rotary steam
engine (wood
engraving), above



"Watson, come
here, I need you":
Alexander Graham
Bell, 1876



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THE INNOVATION ECONOMY

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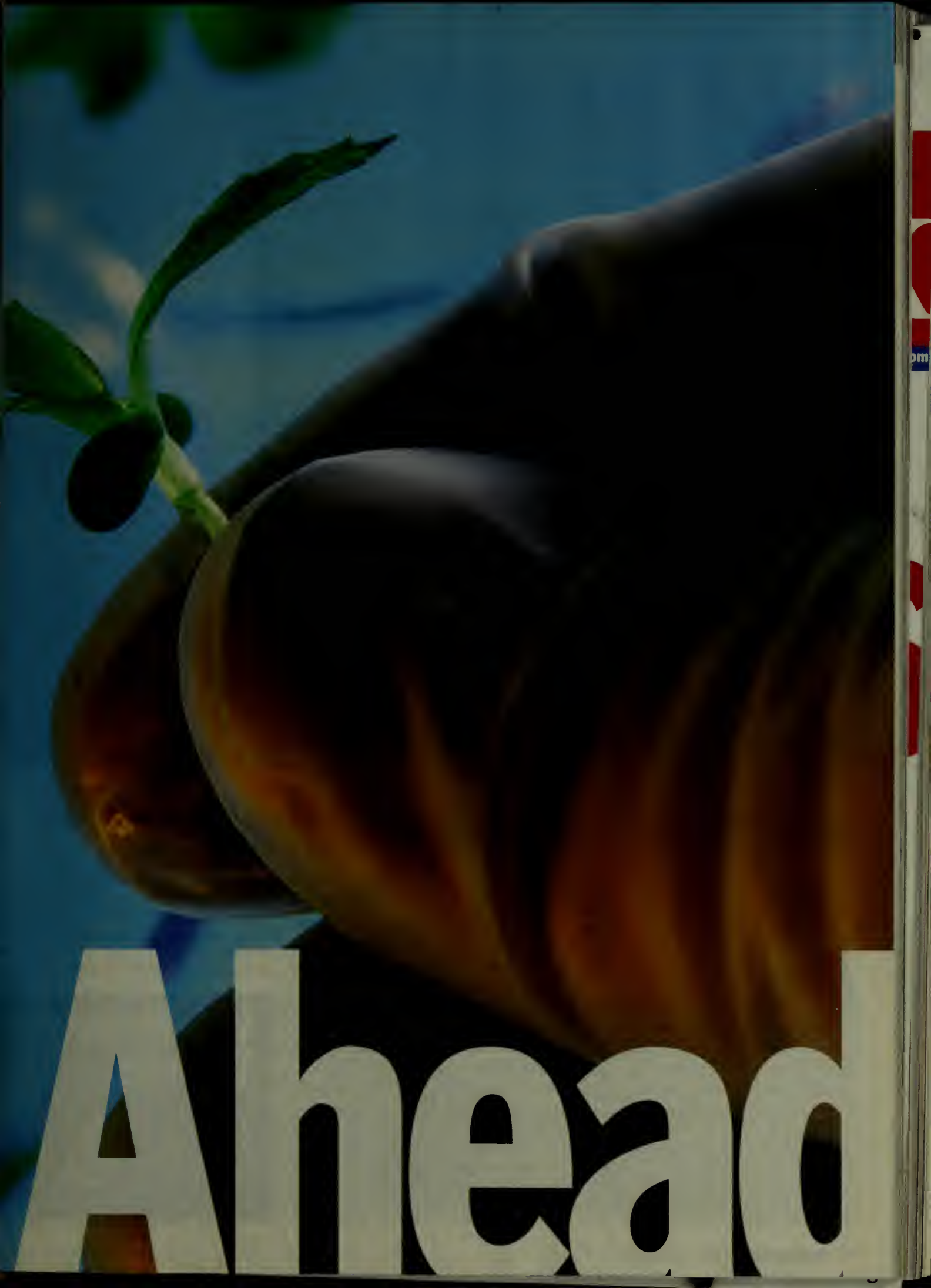
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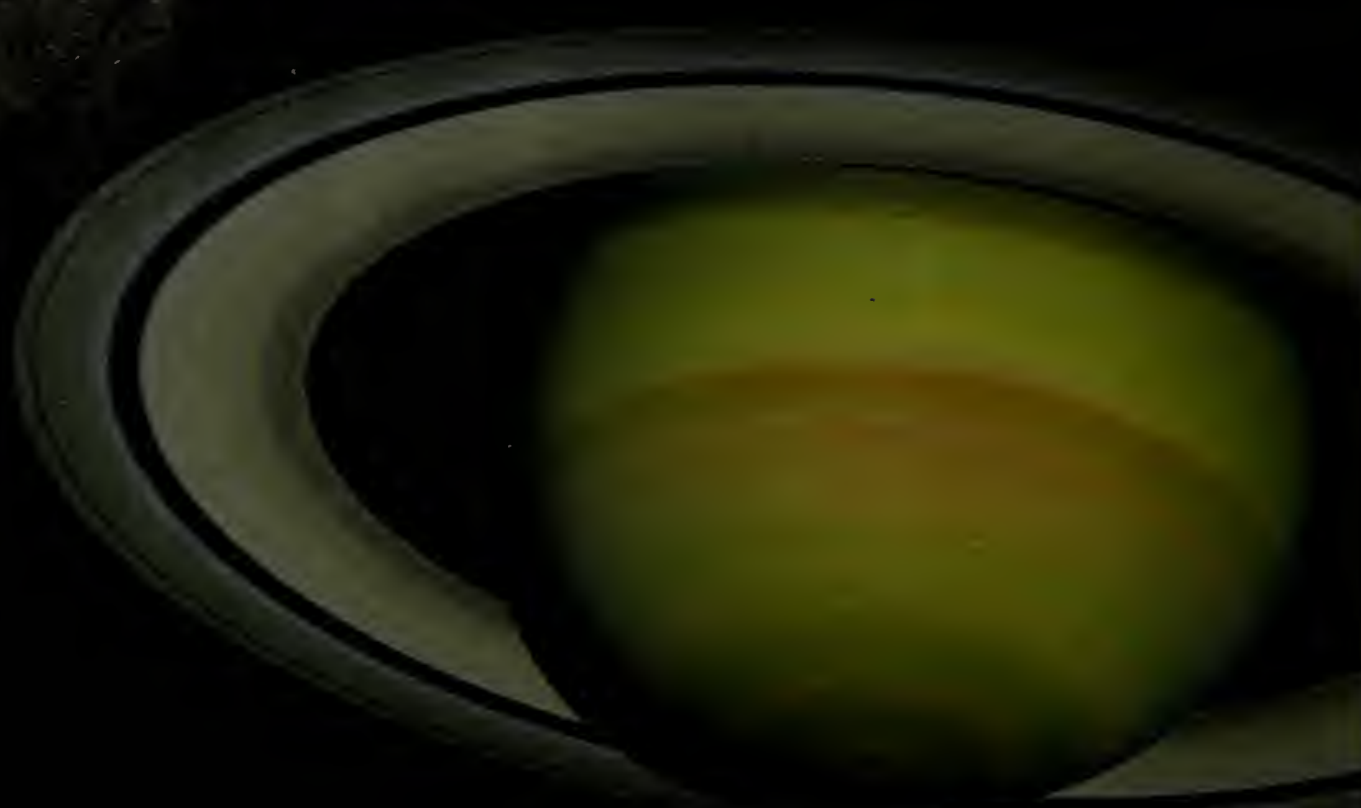
A genetically engineered seedling in a biotech laboratory

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What's



Ahead



Flying High?

Long the innovation leader, the U.S. now has serious competition from abroad. Is America's research lead in danger? By John Carey

AMERICA'S TECHNOLOGICAL MIGHT has made it possible for humankind to probe everything from the rings of Saturn to the structure of atoms. But now the U.S. is facing stiff challenges from abroad. Korean scientists have made breakthroughs in cloning. Britain is a leader in studying stem cells, which offer promise in many disease areas. World-class research labs are springing up in India, Singapore, Taiwan, and, especially, China. And even as the world invests more in science and technology, there's a growing chorus of worries at home about the health of U.S. research. The fears: America is underfunding breakthrough science, failing to educate its own citizens well enough, and alienating talented foreign-born students, scientists, and engineers with a tangle of new immigration policies. "Our only real advantage is in knowledge—and we are not doing well," warns Norm Augustine, former CEO of Lockheed Martin Corp. Adds Nobel laureate and

Massachusetts Institute of Technology physicist Jerome I. Friedman: "We are living off the investments of the past."

How grave are these threats to America's future in science and technology? "We can be scared, perhaps very scared, or we can say that we are still bigger and

better," says Diana Hicks, chair of the School of Public Policy at Georgia Institute of Technology. "You can argue either way, based on the evidence." The best assessment, though, is that America is not yet in any large peril. Certainly, there are

U.S. Research Worries

While overall spending is high, R&D growth has slowed and the bulk of the increases are in just one area: biomedical research

LONG VIEW

Saturn, as seen by the Hubble

stitutes of Health budget doubled in the five years before 2003, rising to \$27.2 billion and helping to make America the world's biotech powerhouse. And overall, the U.S. spends 2.7% of its gross domestic product for R&D, compared with, say, 1.9% for the European Union.

All of that is good for America and good for the world, as the innovations streaming from U.S. labs help improve computing and communications and fight diseases, among many other benefits. Nevertheless, lurking under the impressive overall figures are some disturbing facts. U.S. R&D spending has leveled off since 2000. Budget analyst Jules J. Duga of the Battelle Memorial Institute calculates that companies' estimated 2004 R&D spending of \$181 billion will mark the fourth consecutive year of small decreases (after adjusting for inflation).

WHAT ELSE IS NEW?

AND WHILE UNCLE SAM'S contribution has increased to a record \$89 billion for 2004, big boosts for biomedical research, along with defense and homeland security R&D, have come at the expense of other crucial disciplines. Government funding for the physical sciences, which in the past spawned everything from semiconductors to carbon buckyballs, has stopped rising (in inflation-adjusted dollars). In today's superfast world, yesterday's "big thing" becomes a commodity and moves to lower-cost offshore factories, says Stanford University physicist Burton Richter, a Nobel laureate: "So now, if we don't fund the physical sciences, where will the Next Big Thing come from? We don't generate new ideas like we used to." That's why Richter is spearheading an effort to increase federal support for basic research in the physical sciences.

So far, no data support the idea of a significant slowdown in U.S. innovation. With more than 10 million people with

Washington's research outlays will set a record in 2004, but funding for the physical sciences continues to decline

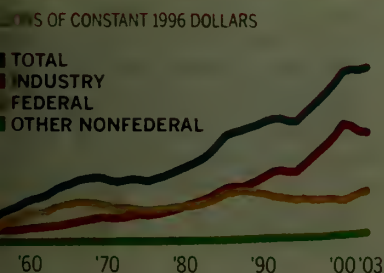
degrees in science or engineering, America still leads the world in scientific papers and patents. But other nations are catching up fast. Within a few years, China plans to graduate 350,000 new engineers annually. In contrast, U.S. universities produce less than 100,000 per year. And as many other nations invest heavily in science and technology, the number of papers and patents from researchers in Taiwan, South Korea, Hong Kong, and Singapore is soaring. The world is increasingly populated with innovators. "We are at a watershed in the global economy," says Denis Fred Simon of Rensselaer Polytechnic University.

Overall, this global innovation explosion "is a good thing. We want a productive world," says C. Paul Robinson, president of Sandia National Laboratories. But it presents new challenges for the U.S. Companies increasingly need to scour the world for ideas. In the future, "the U.S. can only count on making at most one in five inventions," predicts Greg E. Blonder, a former Bell Laboratories scientist who is now a venture capitalist. The good news is that U.S. researchers appear to be rising to this challenge by tapping into overseas talent. The Georgia Institute of Technology, for instance, is working with Bangladesh scientists on monsoon forecasting and is also collaborating with universities and companies across Asia and Europe in fields such as microelec-

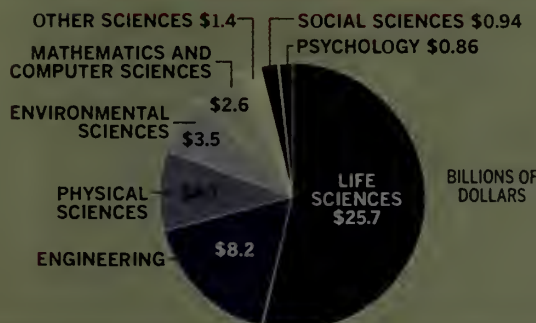
legitimate concerns. But worries now being voiced will increase the chances that corrective steps will be taken, ranging from boosts in funding to streamlining the visa process.

Consider R&D spending. Overall, U.S. investment looks very strong. From 1994 to 2000, total R&D expenditures jumped from \$169.2 billion to \$265 billion, the largest increase for any six-year period in the nation's history. The U.S. National In-

FUNDING, BY SOURCE OF FUNDS



RECIPIENTS OF R&D FUNDING



PERCENTAGE INCREASE 1997-2003

LIFE SCIENCES	95.7%
OTHER SCIENCES	52.9
PSYCHOLOGY	49.6
MATHEMATICS AND COMPUTER SCIENCES	44.4
ENGINEERING	43.8
SOCIAL SCIENCES	20.6
ENVIRONMENTAL SCIENCES	17.2
PHYSICAL SCIENCES	14.3

tronics and advanced sensors. Says provost Jean-Lou Chameau: "Nowadays it would be very arrogant to think that we have all of the research expertise concentrated in one area or country."

Collaboration becomes ever more important as the flow of talent to the U.S. slows. Greater opportunities in countries outside the U.S. mean that fewer foreign-born researchers will be studying, working, and staying in the U.S. The number of visas granted to foreign scientists and engineers has been declining since 2001, aggravated by restrictions imposed to fight terrorism. Because of foreign students' visa troubles, "there has been a precipitous drop in graduate school applications," says James S. Langer, vice-president of the National Academy of Sciences. "It is having a major effect on science and technology in the U.S."

QUICKER CLEARANCE

BUSH ADMINISTRATION officials stress that the visa problem is not easy to solve. "Imagine the outcry if we let a terrorist in to study biological methods or physics," says C. Stewart Verdery Jr., Assistant Secretary for Border and Transportation Security Policy and Planning at the Homeland Security Dept. Still, he says: "We agree that if we make it unduly difficult for people to come and work in high tech, we will have done serious damage."

That's why the Administration is taking action. And there may be reason for optimism on the visa front. A Sept. 7 letter to the scientific community from the State Dept. claims that "98% of all Visa Mantis

MOTOR MOUTH
SRI is working on solid-state artificial muscle



cases [which involve a security check designed to protect against sensitive technology transfers] are being cleared in less than 30 days." While skeptical scientists are waiting for firm proof, "we have seen a really big improvement in the rate at which cases are being cleared," says Wendy D. White, director of the Board on International Scientific Organizations at the National Academy of Sciences.

No such improvement has come in another area of contention—stem cell research. Scientists charge that the Administration is stifling work that holds the promise of treating a host of diseases. The White House has prohibited federally funded scientists from freely experimenting with all but a small selection of embryonic stem cells because of opposition

from anti-abortion advocates. "In U.S., you have this absolutely ridiculous position on federal funding. Most of the best researchers [in publicly funded labs] can't touch these cells while private companies can do anything," says Austen Smith, director of Edinburgh University Institute for Stem Cell Research. But that could change. California voters will soon decide whether to sell billions of dollars in bonds to support research in stem cell

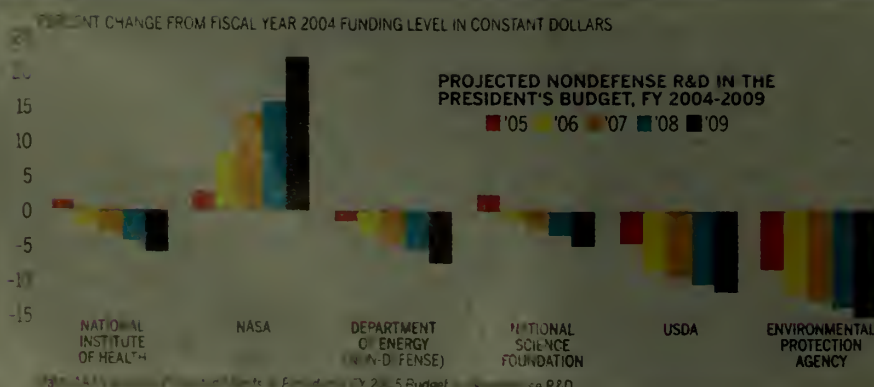
The fears about inadequate research support and slowing immigration are real. But do they strike at the heart of America's technological might, or are they just niggling worries, overshadowed by an innovation engine that still holds awesome power? The complete answer won't be known for years—and, of course, will depend on everything from future R&D funding to visa policies. But past history is any guide, it's unlikely that the U.S. is facing any serious threats to its ability to compete in the world.

Flash back, for instance, to the dark days of the late 1980s and early 1990s when many politicians and scientists lamented that the U.S. was in an irreversible decline. The sense of American supremacy was being rocked by even a new wave of imported Toyotas, Mercedes, chips, machine tools, and Walkmans. Self-appointed rivals of the U.S. rubbed it in. "Americans today make money by shuffling money around instead of creating and producing goods," scoffed Sony Corp. Chairman Akio Morita in the book he co-authored in 1989, *The Japan That Can Say No*.

Japanese arrogance was short-lived, of course. America quickly responded to

Lean Years Down the Line?

With the exception of NASA, nondefense research spending in most areas is likely to shrink



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Shirley Ann Jackson



President of the American Association for the Advancement of Science and president of Rensselaer Polytechnic Institute since 1999.

“Is the U.S. losing students to other countries?

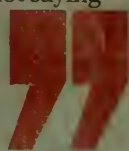
We still are at the top of the heap. But other countries are really racing forward in terms of publications in the major prestigious journals, breakthroughs in certain areas like stem cell research, and production of new engineers and scientists. If you look at countries in Asia on an absolute numerical basis, they produce many more engineers per year.

It's not just a question of where we are on an exact comparison today but on the basis of projecting ahead 10, 15, 20 years. If we don't increase support for basic research and if we don't develop our own talent while continuing to mine talent from around the world, then the question is, where will we be?

What problems will that create?

Technological innovation, coming out of basic research and invention, has been the engine of our economy and has been the basis of our having the highest standard of living in the world. So the stakes are clear.

What we're seeing is erosion, because fewer of our own young people are interested in science and math. Part of it is that [those fields] haven't been viewed as being very glamorous. In terms of early education and performance in science and math, we haven't done so well in recent times. So these things are all going to exacerbate a growing trend—a quiet crisis that could lead to a perfect storm if all these factors come together. I'm not saying our economy is about to fall apart. This is a question of looking at trends that, if left unchecked, can lead to a day of reckoning.



challenge. Companies shook off their complacency, adopting cutting-edge manufacturing tools and coming up with fresh breakthroughs. Bioengineered cancer treatments, the world's fastest microprocessors, world-leading equipment to fabricate semiconductors, software to rig up wireless networks, major advances in a mysterious realm known as nanotechnology—these are but the latest emblems of resurgent American technology. “The story of the '90s is a reminder not to underestimate U.S. R&D,” says Curtis R. Carlson, president and CEO of SRI International. “It's much easier to see the problems than the opportunity.”

HANDWRINGING

WORRIERS concede that the U.S. is hardly in dire straits. “Is the sky falling? No. It's maybe drooping a bit,” says Richter. True, more countries are investing in science and technology than in the 1990s. And we can't count on another Asian stumble. But the game has changed. With companies increasingly searching the whole world for new innovations, it matters less than ever where discoveries are actually made. And even with the new competition, “the U.S. is leading in pretty much all of science,” observes Cherry Murray, senior vice-president of physical sciences research at Lucent Technologies' Bell Labs. It is painful to lose some ground in physical sciences, but “we are doing very well with biology and medicine,” she asserts.

Indeed, for all the handwringing, “I've never seen a time with more opportunity,” says SRI's Carlson. “Everywhere you look, there is one wave of technology after another.” And as the pace of innovation increases, America benefits by having the immense amount of capital and the entrepreneurial culture needed to win the race to market.

Drop in at IBM's Thomas J. Watson Research Center, for example, where solid-state physicist Phaeton Avouris and his team are weaving gossamer threads of carbon, atom by atom, into new kinds of tran-

sistors. Or visit with Dr. Thomas T. Perls at Boston University School of Medicine to learn how people might one day live healthy lives of more than a century. Or explore SRI's spin-off company that's making artificial muscle, a “smart” solid-state material that might replace less efficient motors in everything from air conditioners to automobiles. Or consider a future world that has switched from climate-altering fossil fuels to a host of clean energy technologies, which might include



DARK AGES
Hand assembly of transistors for RCA TVs, circa 1953

a radically different and safe species of nuclear reactor. Meanwhile, researchers are genetically tinkering with microbes and plants to produce not just better crops but

renewable energy as well.

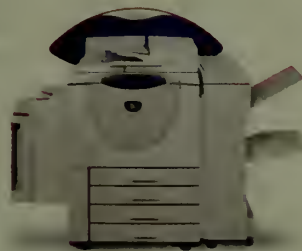
And it's a safe bet that somewhere in America's vast research enterprise, excited researchers are on the cusp of the Next Big Thing—something as revolutionary as the transistor, the Web, or gene splicing. These scientists may not have a clue themselves how their inventions will change the world, just as the creators of the computer, or the laser, or the Internet couldn't imagine the sweeping transformations that their work would eventually bring. But what they do share is a still-undimmed faith in the power of science and technology to probe, illuminate, and, ultimately, improve the human condition. ■

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COMMENTARY

BY JOHN CAREY

Can Uncle Sam's Cash Still Unlock the Future?

IN THE NOW LEGENDARY tale, a small band of visionaries at an obscure Pentagon agency figured out how to make computers talk to each other over great distances, creating what evolved into today's Internet. It was just one example of federally funded research aimed at specific military needs leading to breakthroughs that transformed the world. **J** Are the seeds for the Next Big Thing still being planted in the research supported by the Pentagon's Defense Advanced Research Projects Agency (DARPA) and other government bodies?

Some skeptics worry that today's projects are less bold and far-reaching than those of years past. Not so, argues DARPA Director Anthony J. Tether. "DARPA's only charter is radical innovation," he says. "We try to imagine what a military commander might want in the future and then change people's minds about what is technologically possible." Looking far down the road and throwing money at what you see doesn't guarantee innovation. But it's one fruitful way to inspire heroic efforts from scientists and engineers while leaving the gates open to serendipity.

So what are DARPA dreamers fashioning into reality? One predominant theme: smarter systems. To eliminate the risk of losing valuable and vulnerable pilots, DARPA and contractors such as Boeing Co. are developing swift unmanned and largely autonomous planes (pictured)—with four planes at a time monitored by a single controller—to spot and destroy enemy targets. On the ground, the agency aims to produce vehicles that navigate across almost any terrain, including trackless deserts, on their own.

The wish list isn't confined to the battlefield. DARPA yearns for computer systems that instantly detect and fight off intruders, and for smart sensors to spot danger—from terrorists to submarines—everywhere from war-torn cities to the center of the ocean. The agency is also trying to develop materials capable of sensing and responding to their environments, and tiny, efficient gas turbine engines for small unmanned planes, or for

delivering power wherever it is required. In addition, DARPA has on its drawing board methods for making vaccines against new disease threats in weeks instead of years, and vast computer networks that don't require a team of operators to keep running. The defense applications of these projects are obvious, of course, but pushing the envelope on technology could have far-reaching, if unforeseen, commercial applications. Imagine the impact, says Tether, "if we succeed in our effort to develop computing systems that know what they're doing, and can reason, learn, and are capable of natural interactions with users."

With its \$2.8 billion budget, DARPA represents only a small fraction of the potential seed corn planted by government defense dollars. In the aftermath of September 11, "homeland security has

been a major spark for innovation," says C. Paul Robinson, president of Sandia National Laboratories. One example: Sandia researchers developed a tiny "lab-on-a-chip" for detecting anthrax and other biowarfare agents, which also could help in diagnosing disease by spotting telltale proteins associated with particular illnesses.

Some researchers imagine transforming the world with new tiny devices; others have projects on a massive scale. The Energy Dept. is part of a \$5 billion international effort to build a prototype fusion power plant, which would generate less waste than current fission nuclear plants. It's also plotting to build ultrascale super-

computers that could shave years off developing new jet engines or enable drugmakers to test drugs in silicon simulations. And a huge \$315 million X-ray source promises to open a window on the delicate dance of proteins as they change shape to interact with one another—a key to understanding biology and disease.

The marvel of truly transformational technologies is that they bring capabilities and possibilities that we didn't even know we needed. Almost by definition, therefore, the Next Big Thing is impossible to predict. But a safe bet, always, is to expect the unexpected. ■



STRIKE FORCE
Unmanned
planes spot
and destroy

BusinessWeek online

For additional information about where DARPA, the Energy Dept., and other agencies are placing their research bets, go to www.businessweek.com/75



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*National Highway Traffic Safety Administration frontal crash test: February 2003. EX V-6 model shown.

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TCS
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Hold On to Your Hat

A raft of ideas that could well change your life.

Edited by Adam Aston

INNOVATION IS THAT RAREST OF prizes, often elusive and always difficult to conjure up. Yet we live in innovative times, with new wonders regularly surprising and even delighting us. We have assembled a set of ideas that will soon affect everyday life. Some of these innovations apply clever ideas in a novel way. Carmakers are betting big on fuel cells, but small versions of these chemical power plants are likely to perk up your cell phone first. Other innovations transform old ideas with a smart twist. Think about the roof over your head: By adding a layer of living plants, builders are enriching the environment and cutting energy costs. Or consider that young artists don't know who among them will succeed or flop. Financial engineering to the rescue: Now, they can share the risks by contributing some works to a trust that will sell them years later and split up the profits. Like great art, the best innovations just jump out at you.

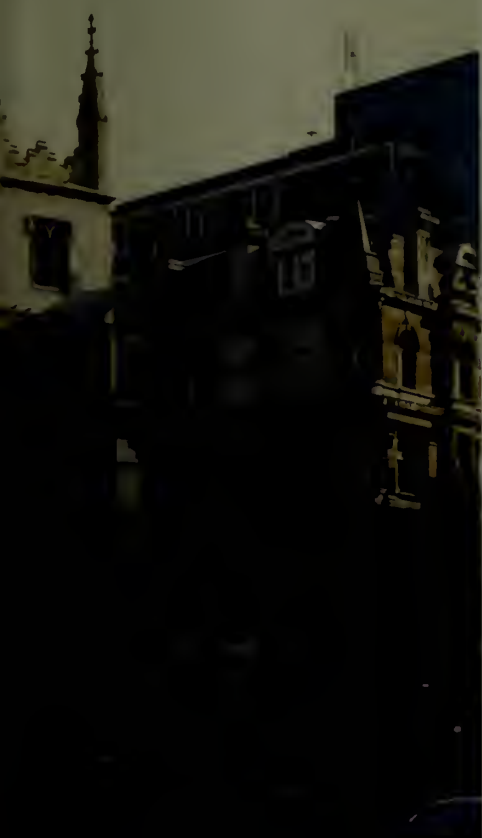


Design Buildings With the Angles Except the Ones You'd Expect

ARCHITECTURE IS GETTING MORE playful. Look at the world's best new buildings and you'll see lots of twists, odd angles, cantilevers—and a distinct lack of conventional right corners. There's Norman Foster's pickle-shaped "gherkin" tower for Swiss Re Insurance Co. in London (left), completed last year. Or think of any recent structure by Frank Gehry, such as the Guggenheim Museum in Bilbao, with its massive metal-skinned forms, tossed together as if by waves.

Technology makes it all possible. Gehry, for example, designs buildings with software evolved from the aerospace industry. The programs can create more extreme designs because they "know" the properties of the steel, cement, and glass they model. They help avoid costly construction errors, too, by spitting out data files that eliminate guesswork and guide machines to make super-precise forms—parts of buildings instead of jet wings.

—A.A.



Medicine Down the Hatch—It Really Is Good For What Ails You

“SWALLOW TWO MEDICINES AND call me in the morning.” Medical gizmos are getting small enough that doctors will soon be prescribing pill-size bits of battery-powered silicon, wrapped in titanium, to diagnose what ails us. A handful of players are perfecting probes that can monitor, record, and even treat conditions.

Today, that means a patient can avoid the discomfort of traditional endoscopy by swallowing a capsule camera such as the PillCam made by Israel's Given Imaging Ltd. As it passes through the digestive tract, onboard LEDs lighting the way, images are transmitted to a receiver worn by the patient. Further out, others are working on tiny implantable devices powered by body heat. Future devices will be able to track multiple indicators such as blood pressure, cholesterol, and glucose levels. When necessary, the implants will even dispense treatment or send an alert to your doctor.

—A.A.

Electronics Soon, Fuel Cells Will Give Gizmos A Bountiful Boost

FUEL CELLS PROMISE TO CHANGE the way we generate electricity and power our cars. But the revolution is likely to start on a smaller scale, in our notebook computers, cell phones, and digital cameras. Consumer-electronics makers are racing to deploy miniature fuel cells to keep their gizmos going and going—long after today's best batteries give out.

Proven by decades of use in NASA spacecraft, fuel-cell technology liberates energy through a reaction between hydrogen and oxygen—no combustion involved. Miniature units use a chemical trick called reforming to harvest the hydrogen from a wide range of liquid fuels, such as the methanol used in lighters. This method does yield a trickle of fumes, but they can be vented or trapped in a cartridge. Either way causes less harm than discarding a battery. And when it runs low, you just fill the unit with fresh fuel.

In terms of longevity, the bunny doesn't stand a chance. MTI MicroFuel Cells Inc. in Albany, N.Y., says its latest offering can boost the standby time of a cell phone to 15 days from three. Mini fuel cells will start appearing in military and industrial uses this year. Your cell phone may have to wait a few years, until the cost comes into line with batteries.

—Otis Port

BusinessWeek online For more examples of innovative products and trends, go to www.businessweek.com/75

Space Please Have Your Boarding Pass Ready At the Launch Pad

SPACE TOURISM WILL BE A multibillion-dollar industry, predicts aerospace engineer and entrepreneur Burt Rutan. Of course, he has reason to be optimistic: In June, Rutan's SpaceShipOne became the first privately developed plane to rocket into space. At press time, Rutan and his sugar daddy, Microsoft co-founder Paul Allen, were hoping to pull off two or three repeats in quick succession. That would show that space planes could operate more like airliners than NASA's shuttles.

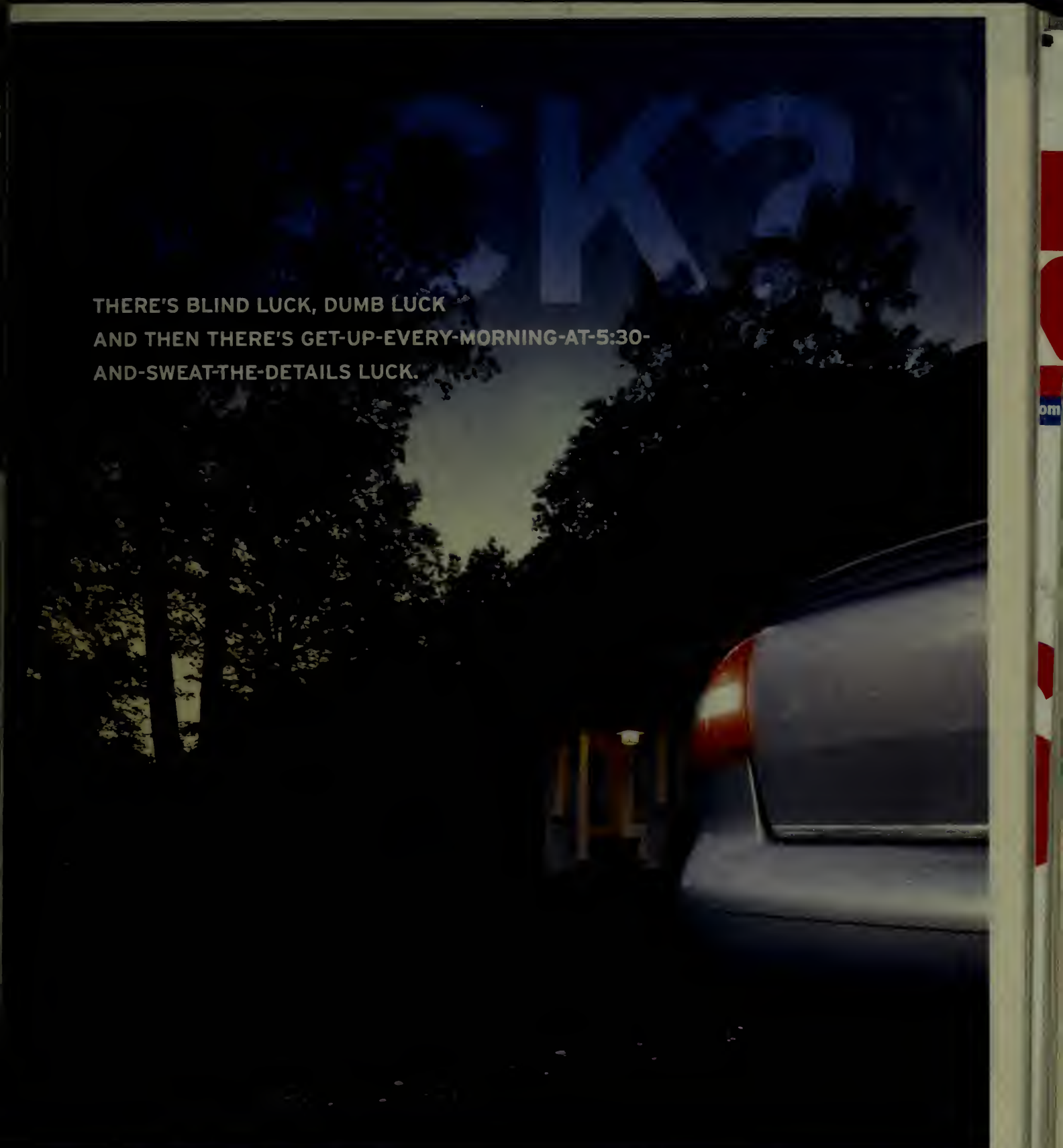
In fact, a space-tourism company is now in the works. Using Rutan's technology, Britain's Virgin Group is branching out from passenger jets to tourist rocket planes. The new venture, called Virgin Galactic, plans to launch its first flights in 2007. Virgin predicts initial flights will cost \$190,000, including three days of pre-flight training. Surveys by the space industry show that at least half of Americans would like to see the Earth from space—if they could afford it. By 2015, competition could trim the price to \$15,000. The Space Frontier Foundation, an industry group, is aiming for even less, maybe \$5,000. —O.P.



Risk A Scheme for Starving Artists to Hatch A Nourishing Nest Egg

AT 28, ZAK SMITH IS A SUCCESSFUL artist. His frenetic pieces go for \$8,000 a pop. But even if buyers suddenly go cold, art will sustain him, thanks to a clever bit of risk-sharing that could have uses in other fields. Smith is among what will eventually be 250 young New York artists, chosen by an expert panel, who are pooling some of their works in Artist Pension Trust. Created by an entrepreneur, an economist, and a former museum director, the program banks on the fact that some of the artists will hit it big, raising the value of the trust. Each member contributes 20 works over two decades, mostly in the early years. Half the payments, which start at retirement, come from sales of the artist's own works; the rest come from the shared sales of the other artists in the trust. That way superstars are rewarded, and slow sellers aren't left out. —A.A.





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AND-SWEAT-THE-DETAILS LUCK.

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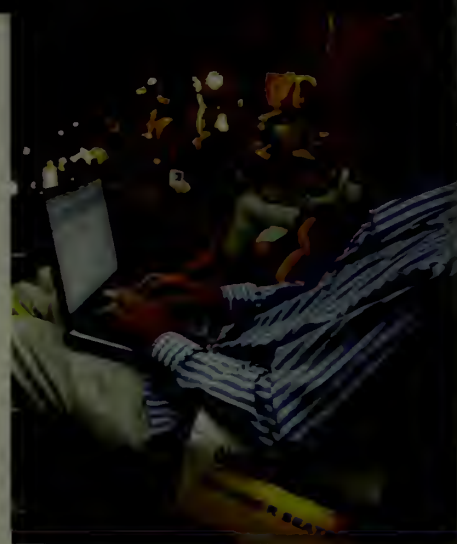
SMITH BARNEY
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Internet Tapping the World's Brainpower with Wiki

» BLOG SOFTWARE REVOLUTIONIZED the Web by making it easy for pundits to post their scoops and diatribes quickly and with little computer expertise. The next step in that revolution is coming from something called Wiki—software that allows not just one but thousands to contribute to a site quickly and easily. One of Wiki's first fruits is Wikipedia.org, a free online encyclopedia of 1 million-plus articles that has been whipped together entirely by volunteers in just four years.

Wiki-based Web sites invite collaboration and rely on trust to prosper. Anyone can see and comment on what others post—say, a contribution on the history of Pittsburgh. Peer pressure generally stops people from posting incorrect or overly opinionated entries. The Wiki software handles all the technical gruntwork of weaving in new contributions. And because Wiki makes it so easy for large groups to cooperate on big projects, companies are starting to check it out, too.

—A.A.



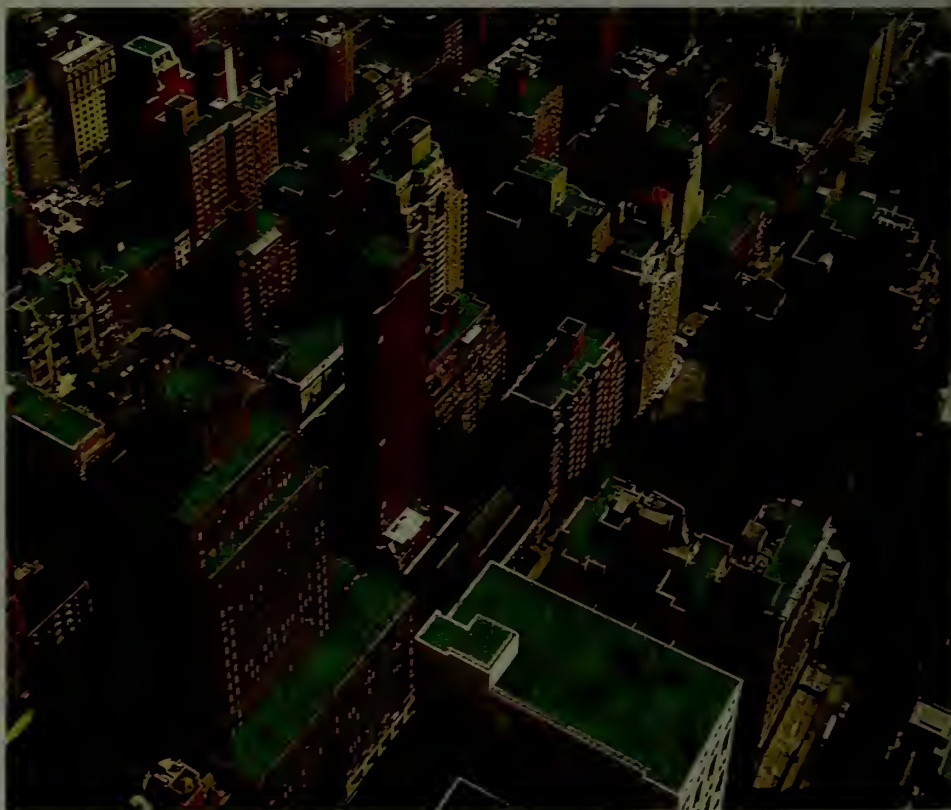
Sensors Wireless 'Motes' to Link Factory Lights and Thermostats

» SOMETIME IN THE NEXT DECADE or so, cheap sensors the size of a grain of salt could give every product a pinch of savvy. Sewn into silk undies, they would tell the washing machine to be gentle. Sprinkled around a house, the

sensors could be linked into networks that might help a home security system keep an eye on things. Or soldiers could scatter this so-called smart dust along enemy lines to keep watch for bioweapons.

Though shrinking fast, today's smart sensors are close to a pager in size and are doing more basic jobs. For example, the first SmartMesh devices (left), made by Dust Networks in Berkeley, Calif., will replace the miles of cabling necessary to link up lights, thermostats, and other sensors in large buildings and factories. Dust Networks'

"motes" do away with the wires—and can slash the cost of installing a single thermostat from \$400 to \$40—by relaying data from one mote to the next. They use low-power radio signals to send short, secure bursts of data. Dust-size motes are still years off, says founder Kris Pister. But bottle cap-like devices will come within five years, he says, followed by aspirin-size ones. —A.A.



Environment How Green Is My Rooftop

» ON A HOT SUMMER DAY, WHEN it's 90F on the street, it can be twice that up on the roof. In most wealthy nations, the majority of residential and commercial roofs are black—made of shingles or tar, holdovers from an era when cheap, oil-based material was the best option. Yet a black roof drives up air conditioning bills as it absorbs and holds the sun's heat. There is a cooler solution: make the roof white, or better yet, cover it with vegetation.

This trend began in Europe in the 1980s and is now catching on in Tokyo, Chicago, and New York. "Green" roofs are built

similarly to traditional watertight roofs, but with a final layer of living plants and dirt or synthetic soil. From hardy groundcover to ornamental foliage, plants help cool a building in the summer and insulate it in the winter. They also clean the air, reduce water runoff, and look better than blacktop. Green roofs can last about three times longer than black ones because the plant life limits temperature extremes and damage from ultraviolet rays. Factor in lower energy bills, and Earth Pledge, a nonprofit group, figures that going green is cheaper in the long run.

—Sarah R. Shapiro

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Medicine Finding the Magic RNA Bullet to Stop Disease in Its Tracks

THE DISCOVERY THAT RNA CAN shut down harmful biological processes has electrified molecular biologists. Until recently, RNA was understood as the humble single-stranded cousin of the double-stranded master gene, DNA. Its only known role was that of messenger, simply translating DNA code into proteins.

Here's the twist. When cells are sick, they can send out harmful RNA instructions, enabling viruses to replicate or cancer cells to multiply. By harnessing the newfound phenomenon known as RNA interference (RNAi), biologists trick cells into destroying bad RNA messengers. The biologists make bits of RNA that are genetically similar but double-stranded. The cells attack those

oddballs—and kill the bad messengers in the process.

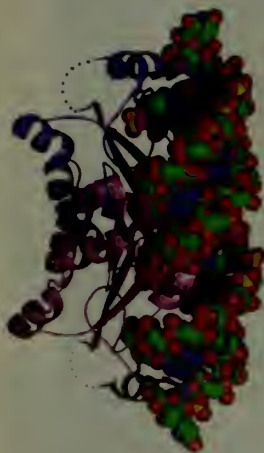
Universities, big drug labs, and startups are racing to discover magic RNAi bullets for treating everything from eye disease to HIV/AIDS.

Cancer researchers are exploring how RNAi can reverse

the resistance patients build up to chemotherapy drugs. With nearly half of all cancer treatments hindered by such resistance, the findings suggest that complementing anti-cancer drugs with RNAi would boost a treatment's overall effectiveness.

These promising early findings should be interpreted with caution. Many diseases are likely to prove responsive to some form of RNAi, but researchers have just begun to identify the pathways unique to each disease. Another challenge is finding a way to deliver the RNA to the right cells throughout the body. In trials to treat macular degeneration, RNA is being injected directly into patients' eyes. In the bloodstream, by contrast, unmodified RNA can degrade, which may limit its value as an oral or injectable treatment.

—A.A.



Energy Ceramics Could Help Keep the Lights On

ELECTRICAL RESISTANCE eats up an enormous 7% of the world's power output. Such waste might start to shrink now that new superconducting materials are emerging from the lab.

Many metals lose all resistance to electrical current when cooled to near absolute zero, -460F—but that's too cold to be economically feasible. Luckily, certain ceramic compounds superconduct at -300F and below, which is within the ability of liquid nitrogen, a relatively cheap industrial coolant, to achieve. Engineers have also learned how to turn these so-called high-temperature superconducting (HTS) ceramics into wires and cables.

The first big-time commercial HTS applications, perhaps starting next year, will be in industrial motors and substations on the grid. Today's transformers, for example, waste power in the form of heat. Experts figure that upgrading them with HTS units could cut power-distribution losses nearly in half. And HTS transformers are more tolerant of power spikes and surges in hot weather. That means less likelihood of brownouts and blackouts.

—O.I.

Food Fast Protein from Backyard Fish Farms

AS ASIA'S POPULATION GROWS wealthier, global demand for protein is on track to outstrip the supply of feed necessary to raise all the chickens and cows we'll need. Fish are a better idea: They need less food to generate each pound of flesh. Yet due to a lack of global cooperation, fish are often harvested until too few are left to catch. And today's fish farms can poison nearby waters with rotting food, chemical additives, and fish waste. The answer could be high-tech urban fish factories around the world.

In a basement at New York City's Brooklyn

College, biology professor Martin P. Schreibman is proving the point with a high efficiency system of tanks and filters, filled with thousands of tilapia—favored for their flaky, light meat. By filtering out waste and carefully managing the water chemistry and food volume, the high-density setup can raise thousands of fish in a small space with little labor. The system works in dry climates, too, by recycling its water. And since it can be built near consumers, transport costs are lower. That could mean fresher, cheaper fish for all.

—A.A.





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Universe In a Grain Of Sand

Scientists are finding that ultratiny materials behave in unexpected ways. By Stephen Baker and Adam Aston

IT WAS A SHINING MOMENT. Four years ago in a University of Texas chemistry lab in Austin, two professors, Brian Korgel and Keith P. Johnston, placed bits of silicon in a pressurized titanium chamber. They poured in a brew of solvents and then heated it to 932F. What emerged from this pressure cooker were itsy-bitsy crystals of silicon, visible only under the most powerful microscopes. But something was very peculiar about silicon at this atomic scale. It wasn't its usual sandy self. Far from it. These so-called nanocrystals, when hitched to electrical current, emitted steady light. ¶ That glow attracted venture capitalists. Hungry for advances in the budding field of the ever-so-tiny—nanotech-

nology—they financed a lighting startup, Innovalight Inc., and pushed the inventors to file a dozen patents. These days the new company, based in the dry hills west of Austin, is engineering those crystals for the marketplace. These specks are as tiny next to a soccer ball as that ball is to earth. Yet Innovalight is betting that gazillions of them eventually will light up homes and offices. "We want to replace the light bulb," says Innovalight CEO Paul Thurk.

In labs throughout the world, from research universities to blue-chip multinationals, scientists are weaving nanoparticles—measured by the billionth of a meter—into outsized dreams. They see these bits eventually targeting and destroying cancerous tumors, revolutionizing electricity generation with ultra-efficient solar cells, and forming into platoons of microscopic disease monitors to be deployed inside the human body. They're planning for the day when semiconductors built of nanoparticles replace silicon—and usher in an age of comput-

ers powerful enough to rival the human mind. There's even a plan to link earth to a space station with a pillar built of superstrong nano materials, stretching thousands of miles straight up.

A VAST CHEMISTRY SET

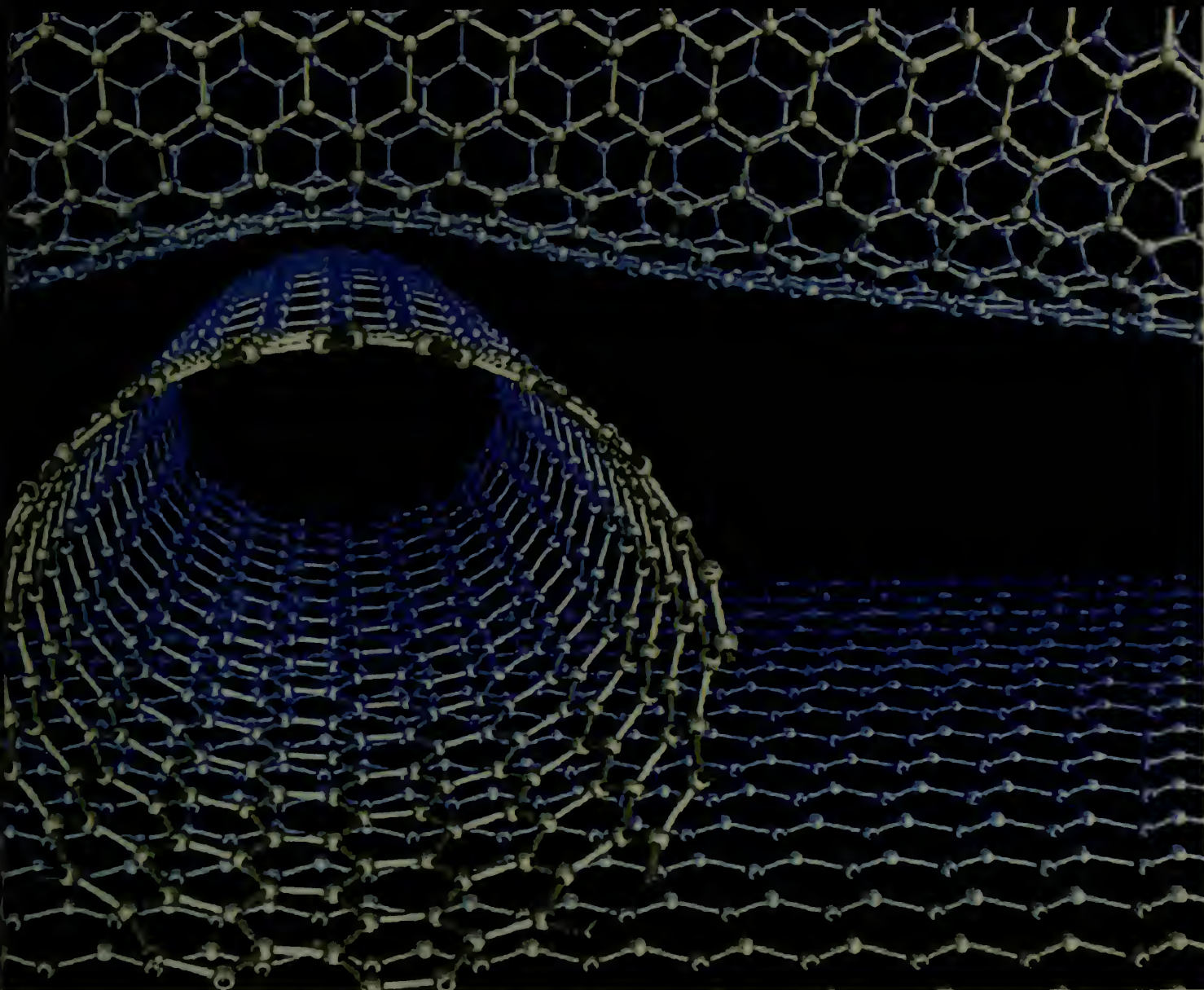
THESE OUTSIZE AMBITIONS would amount to a dizzying to-do list for any single technology. But that's where nano's name sows confusion. Think of nano not as a technology but as a minute scale of engineering. An assortment of marvelous tools—from atomic-force microscopes to powerful imaging software—has cast open the doors of the atomic world to researchers everywhere. This gives them a rich universe to explore. Three centuries ago, scientists marked a similar advance when they peered through the first microscopes and witnessed the teeming world of microbes and protozoa. That set them on the path to modern medicine. Their heirs today have first crack at manipu-

lating the very building blocks of matter.

The job ahead, which promises to be a defining enterprise for the 21st century, is to reengineer, atom by atom, the physical world. Why bother? Scientists are discovering every day that even familiar materials can behave altogether differently when reduced to ultratiny pieces. Break down gold into small enough bits and it becomes a catalyst. Other materials emit light or turn into superconductors of electricity. Why the differences? Mysteries still abound. While scientists understand that electrical properties undergo transformations at these nano sizes, says Texas' Korgel, they still struggle to understand many of the changes—and more to predict them.

The result is that nanoscientists face what amounts to a vast chemistry set full of new materials and tantalizing possibilities. Biologists, physicists, chemists, and electrical engineers have the chance to invent materials at the molecular level and create tailor-made metals, fabrics, tissues,





and membranes. "Nanoscience is about redoing everything," says Chad A. Mirkin, director of the Nanotechnology Institute at Northwestern University in Evanston, Ill. "Everything, when miniaturized, will be new."

To be sure, the transforming potential of nanotechnology generates its share of hype. Similar revolutions, most recently in biotech, have delivered on only a fraction of their promise. And plenty of nano initiatives are certain to run aground between the lab and the marketplace. Innovalight's bid to replace the light bulb, for example, is just one in a galaxy of nano long shots. What's more, concerns about nanoparticles polluting the environment could fuel opposition to new materials and create regulatory hurdles. And schemes to unleash nano agents inside the body, whether to zap cancer cells or to break down a diabetic's glucose, must first demonstrate conclusively that the agents won't pile up harmfully in the body or seep—heaven forbid—into the brain.

Yet even if certain applications fall flat and timetables run amok, there's no turning back from research on the nano frontier—not now that scientists the world over are exploring its wonders. Such a retreat would be akin to telling Dutch biologist Antonie van Leeuwenhoek in 1668 to toss his microscope in the nearest canal and settle for squinting at germs with the naked eye. What's more, entire industries are banking on advances in nanotechnology not just for en-

hancements but for salvation.

Take semiconductors. For decades chip-makers have been shrinking their circuitry and jamming more and more transistors onto wafers of silicon. This relentless process has doubled computing power per chip about every 18 months, as predicted more than three decades ago by Intel Corp. co-founder Gordon E. Moore. But Moore's law may be bumping up against its limits.

Chips are getting mighty crowded. The insulation that protects ultrafine metallic wires is becoming so thin—in places only a few atoms thick—that electrons can tunnel through it, hurting performance. Worse, each new transistor generates extra heat. Soon there will be so many that some chips could reach the temperatures of rocket nozzles—and melt. "We know the road ahead will hold through 2015," says Paolo A. Gargini, Intel's director for technology strategy. "But by 2020

NANOTUBE
Carbon wires
a billionth of
a meter wide

**>> Nanotech
is expected
to renew
the chip industry—
and fuel innovation
in every field
of science**

we'll have to enter a new regime."

Enter the carbon nanotube, the closest thing yet to a jack-of-all-trades in the nano world. Discovered 13 years ago by a Japanese researcher, these cylindrical wisps made of carbon atoms are shaping up to be a pillar of the nano age. They are as much as 100 times stronger than steel, and they can be tuned to resist electricity or to conduct it efficiently, emitting little heat. The hope is that nanotubes could provide both the structure and the circuitry of a future generation of semiconductors. That would give the chip industry a new lease on life. And the resulting explosion of computing power would fuel innovations in every field of science. Think of modeling the brain, of planting immense computing power into artificial ears and eyes, of forecasts that pinpoint the path of tomorrow's tornadoes.

MEMORY EXPLOSION

TECH COMPANIES ARE just starting to piece together this vision. At IBM's Thomas J. Watson Research Center, researchers have assembled prototype nanocircuits. But they're still far away from a mass-scale technology that could power the \$200 billion chip industry. "Going from lab to development to production, there are many oceans to cross," says Venu Menon, Texas Instruments' vice-president for silicon technology development.



For the next decade, look for nanotubes to take up supporting roles in computing—starting with a splash in memory. At a Woburn (Mass.) startup called Nantero Inc., researchers are putting together a high-performance memory stash made entirely of nanotubes. Billions of them are dropped on a chip, like a microscopic

GOODBYE TO BULBS? InnovaLight's Thurk is betting that silicon nano crystals will illuminate the future

plate of spaghetti. Within this thicket, each strand can capture a bit of digital information, bending to form the one and staying flat for zero. Nantero, which is nearing the manufacturing stage, aims eventually to develop chips that pack a terabyte of data—1,000 gigabytes, about the contents of a municipal library—onto a space the size of a credit card.

The miracles of miniaturization will provide medical researchers with powerful new tools, from arrays of tiny sensors to minuscule drug dispensers lodged in the body. This is nanobiotech. Despite fear of nano agents going haywire, research races ahead. In labs in Hayward, Calif., scientists at Quantum Dot Corp. are experimenting with "q-dots"—nano-size semiconductors that glow in different colors. By tweaking their size and coating, researchers can dispatch particles to different kinds of cells.

In studies, the q-dots have lit up the lymph systems of pigs in great detail, making it easy for doctors to identify diseased areas. Others hope to use the same process to target and cook cancer cells.

That's ambitious, but it's not in the rarified league of the space elevator. The idea is that the immense strength of carbon nanotubes would allow for the construction of a singular skinny beam a yard wide and tens of thousands of miles long. This pillar would extend straight up, like Jack's beanstalk, far beyond earth's atmosphere and hitch to a space station hovering in geosynchronous orbit. Little pods would shimmy up and down this stalk with provisions, carrying out the work now handled by rocket launches—for one-thousandth the cost.

Yes, it sounds absurd. But NASA-backed researchers aren't laughing. They're busy studying how to weave nanotubes into threads—and those threads could later become cables. The nano frontier, they know, will be alive with surprises, many of them still beyond imagination. And who knows? If nanotechnology makes good on even a handful of today's visions, from replacing silicon to fighting cancer, someday the space elevator might sound like a sensible idea. ■

BusinessWeek online For more on how nano fever is shaking up universities, go to www.businessweek.com/75

Nanotech's Grand Vision

■ Groundbreaking advances in nanotechnology are expected to spread through the economy, shaking up entire industries

	VISION	PROGNOSIS
FIGHT CANCER	Sensors will be able to detect a single cancer cell and will help guide nanoparticles that can cook tumors from the inside out, leaving healthy cells alone.	Diagnostics will hit the market within three years. But treatments carry far higher risk. Testing and government approvals will delay them for the next decade.
TRANSFORM ENERGY	Nano-enhanced solar panels will feed cheap electricity onto superconducting power lines made of carbon nanotubes.	Next-generation panels will emerge this decade in Japan, which leads in the technology and suffers from higher energy prices.
REPLACE SILICON	Carbon nanotubes will take over when silicon peters out, leading to far faster chips that need less power than today's	IBM has built working nanocircuits. But in the factory chipmakers must be able to make billions of them. The transition is unlikely before 2015.
TRAVEL TO SPACE	Podlike "crawlers" will carry cargo thousands of miles up a carbon-nanotube cable to a space station—for billions less than rocket launches	Today the longest nanotubes are mere millimeters. To make miles of cable, scientists must learn how to weave these into threads. A working cable is at least 20 years away.

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Where Our Energy Will Come From

From seabed gas to pebble-bed nukes, a scouting report on tomorrow's sources. By Michael Arndt

THE WAY WE PRODUCE and consume energy hasn't changed much in decades. Sure, you might spot the occasional hybrid gas-electric car or a high-tech windmill. But research in the field hasn't been energetic. No surprise there: Except during the crises of the '70s, fossil fuels have usually been cheap and abundant. The next few decades promise to be vastly different. Driven by escalating prices, geopolitical instability, global warming, and pollution, governments and companies around the globe are stepping up the hunt for new ways to power the economy. The ambitious goal: plentiful, clean, and secure forms of energy and less wasteful ways

to employ them.

The effort spans everything from hydrogen-powered cars to safer nuclear reactors to solar power, efficient lighting, and methane from the ocean floor. Of course, some of the efforts may never pay off. The nearly \$10 billion spent by the U.S. Energy Dept. on nuclear fusion research, for example, has borne little fruit. And private companies might unplug their energy research if prices drop again. Still, the pressure for breakthroughs is stronger than it has ever been. "We must find alternatives," says Amos M. Nur, a geophysics professor at Stanford University, who calculates that world oil output is near its peak. "If we don't, we'll soon be in big trouble."

Here are some of the technologies that could make a difference in the next couple of decades:

NO SMOKING
Hydrogen-powered buses keep the air cleaner in London

HYDROGEN REDUX

AS FAR BACK AS THE LATE 1700s, city streets, public buildings, and homes in Europe were lit with a hydrogen-rich gas derived from baking coal. Town gas, as it was often called, remained widely used in much of the world until the early 1900s, when the marketplace moved to natural gas or electricity. Now, governments of many industrialized countries are trying to bring hydrogen back—th



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time as the motor fuel of the 21st century.

The move to hydrogen has already begun—slowly. Major carmakers have developed engines that can run on the lighter-than-air element instead of gasoline. They also know how to manufacture fuel cells that combine hydrogen and oxygen to generate electricity, with double the energy efficiency of the internal combustion engine. Iceland, which has abundant geothermal energy for separating hydrogen, already has hydrogen-powered buses and filling stations. The government there has vowed to switch the entire economy over to hydrogen within 50 years.

Even hydrogen proselytizers acknowledge, however, that immense obstacles remain. What's still lacking—and essential—is a cheap, nonpolluting way to generate the energy to derive pure hydrogen, which comes from either water or hydrocarbon fuels such as methane. Also, on a horsepower basis, fuel cells cost five times as much to make as internal combustion engines. And the fuel tank in today's prototypes takes up the whole trunk.

In the U.S., the Energy Dept. is spending \$1.7 billion over five years to chip away at these problems. Researchers have already cut fuel-cell manufacturing costs by 95% since 1990. If they can re-

» In pebble-bed modular reactors, a rise in heat slows down the nuclear reaction, which safeguards against meltdown

duce those costs further, the payoff could be big. If just one in 100 cars and light trucks in the U.S. were fueled by hydrogen, 4 million gallons of gasoline would be saved every day.

PEACEFUL NUKES

A NEW NUCLEAR RACE is under way, and this one is peaceful. As early as next year, rival quasi-governmental teams in China and South Africa aim to begin building commercial-scale atomic reactors that would depart radically from current designs. A similar plant in the U.S. could be close behind: Introducing the PBMR, or pebble-bed modular reactor.

Today's nukes are behemoths that use rods of uranium undergoing fission to make superheated steam, which in turn drives turbines to generate electricity. PBMRs, for their part, are compact units fueled by thousands of ceramic-encased spheres of uranium, each about the size of a billiard ball, which heat a chamber of helium to spin the generators. By using helium instead of steam, the plants should be at least 35% more efficient. Pilot projects have shown the design to be inherently safer: The ceramic shell locks in radioactive by-products, and the nuclear reaction slows as the chamber gas gets hotter, a safeguard against a meltdown.

Pebble-bed modular reactors aren't perfect. They still produce nuclear waste that would remain dangerously radioactive for ages. But industry and government are starting to rethink nuclear power as other fuels lose favor. Without new technology, coal is on the outs because it's dirty and emits greenhouse gases, while cleaner-burning natural gas has become pricey. Uranium is inexpensive and doesn't dirty the air.

Authorities in China and South Africa expect to have demonstration plants on line around 2011. China, in fact, is talking about building over the next 20 years 3

SEASIDE SERVICE

New terminals for LNG tankers would aid imports of cheaper gas



The Future of Energy

Progress in the technology of energy has been slow, but some new ideas are on the horizon

HYDROGEN FOR POWER

PROS A clean substitute for gasoline and other fuels

CONS Consumes more energy to make than it yields

NEW ATOMIC REACTORS

PROS A safer, more efficient design, plus no greenhouse-gas emissions

CONS Many still hate nukes, and there's a waste-storage problem

METHANE HYDRATE

PROS A super-abundant source of clean-burning natural gas

CONS Sea floor deposits cannot be tapped using conventional wells

LIQUEFIED NATURAL GAS TERMINALS

PROS Lets the U.S. and others import big amounts of cheap natural gas

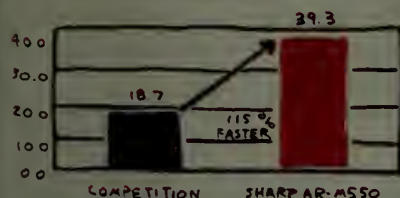
CONS Facilities are costly. Neighbors fear explosions

SOLAR POWER

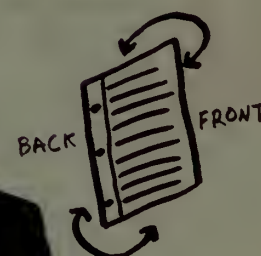
PROS Renewable and non-polluting source of electricity

CONS Still more expensive than fossil fuels; needs a sunny setting

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A professor at Columbia University's Lamont-Doherty Earth Observatory and a leading researcher on the issue of global climate change.

“Can we take action against global warming without seriously harming the economy?”

A lot of people think we can take the steps needed at a cost of 1% to 2% of global gross domestic product. But it's not all negative. It would create new industries and bring a lot of construction work. And while time is short, it's not that short that we have to turn everything upside down and only spend money on this right now. When we stand way back and say, “If we could solve this problem for 30¢ more a gallon of gas,” most people in the world would agree to that. It's not going to break us.

Are there innovative ideas for tackling the problem?

There's only one sure solution, and that's capturing CO₂ and putting it away. [i.e., grabbing the carbon dioxide as it's produced when fossil fuels are burned, and storing it deep underground or turning it into rock.] It's not the only solution, but I think it's the ultimate solution.

What are the consequences if we don't try to combat global warming?

We still don't understand the mechanisms [of climate change], and it's scary that we can't tell what the future may bring.

It is a vast problem, and a dangerous experiment. Maybe Lindzen [Richard S. Lindzen, professor at Massachusetts Institute of Technology and a noted skeptic of global warming] is right, and climate change will be a big bust. But to bet on that happening would be very dangerous.



such reactors to meet surging demand for electricity. In the U.S., the Energy Dept. is planning to sponsor a PBMR in Idaho, with a 2012 startup target.

METHANE MOTHER LODE

THE U.S. IS PRODUCING about the same amount of natural gas as it did 30 years ago in spite of soaring demand. Improved technology can't overcome the depletion of fields. As a result, natural-gas prices in the U.S. have more than doubled since 1999. The solution could come from a surprising place: the sea bottom.

Buried just below the ocean floor along the continental slopes as well as in the Arctic permafrost are vast deposits of crystallized natural gas suspended in ice, known as methane hydrate. The U.S. Geological Survey reckons global reserves of methane hydrate contain twice as much energy as the world's proven deposits of oil, natural gas, and coal combined.

But no one has yet figured out how to exploit this energy source economically. Methane hydrate is too dispersed among the sediment to be pumped to the surface like gas or oil. Dredging doesn't work well, either, because it would mean scooping up tons of muck and hoisting it to the ocean surface for separation.

Working with the Energy Dept., ChevronTexaco Corp. is heading an international consortium that has identified sites in the Gulf of Mexico that appear to contain storehouses of methane hydrate. The oil giant plans to sink wells next spring to bring up core samples and get a better idea of how to recover the gas. Energy-short Japan and India are also digging into methane hydrate. Researchers hope to hit pay dirt by 2025.

INTERIM SUPPLY STRETCHERS

INCREMENTAL INNOVATIONS in other arenas could tide the world over until these longer-term solutions are realized.

Imports of natural gas could ease the supply squeeze within a few years. Following the example of Japan, South Korea, and Western Europe, American energy companies have filed plans for some 40 ship terminals that would allow for a vast increase in imports of super-cooled, liquefied natural gas on specially made ships. Sempra Energy is furthest along. The San Diego company plans to begin building an LNG receiving terminal in Louisiana and another in Baja California later this year. By 2007, the company says, at least three terminals will be completed.

Other companies are working on lighting technologies that extend power supplies. Many municipalities are installing

signs with clusters of light-emitting diodes instead of incandescent light. They consume one-tenth the electricity and last up to 100 times as long. General Electric, Royal Philips Electronics, and other companies are racing to come up with affordable diodes that will work in regular room settings.

Solar power is advancing, too. Photovoltaic panels—thin sheets of semiconductor that turn the sun's photons into electricity—are becoming more common in Japan and Germany, where governments are funding research, and in developing areas such as rural India and



HOT PROSPECT Methane hydrate is easy to burn but hard to extract

Nigeria, which often lack an electric grid. As costs sink and efficiency rises, solar power could be “a huge opportunity,” says Stephanie A. Burns, CEO of Dow Corning Corp., the leading producer of silicon for solar panels. “We're right on the cusp between what's an engineering project and what's a real product,” adds Daniel P. McGahn, executive vice president at Konarka Technologies Inc., a Lowell (Mass.) company that is trying to build solar power capacity into a wide variety of products. “We want to cut the final wire.”

Decades from now, the world's commuters may still be driving gasoline-powered cars. And power plants, retrofitted further to reduce emissions, may still be burning coal. But who knows? Given the potential of the energy projects underway, they may be as rare as hybrid vehicles and windmills are today. ■

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Kirk Douglas,
at about 30



Aging Is Becoming

Tantalizing new discoveries suggest the possibility of reengineering the body. By Catherine Arnst

THE NEW ENGLAND CENTENARIAN STUDY collects data on people 100 and up, with 1,500 very senior citizens enrolled. It's getting easier to find subjects—there are 40,000 such people in the U. S., and it's the fastest-growing demographic segment. This could be because the very old are unusually resistant to the ravages of age. Surprisingly, long-lived people don't necessarily make it because of their lifestyle. Dr. Thomas T. Perls, associate professor of medicine at Boston University School of Medicine and chief investigator of the Centenarian Study, reports that many of his subjects spent much of their lives eating fatty foods, drinking alcohol, ex-

ercising sporadically—and, in 20% of cases, smoking. They come from all social and racial backgrounds. Common denominators: They generally are thin, handle stress well, and are female (85%). One role model is Jeanne L. Calment, believed to be the world's oldest person when she died in 1997 at 122. She quit smoking only two years before her death and attributed her long life to port wine, a diet rich in olive oil, and a sense of humor.

Perls's research indicates that Calment may have had something more basic going for her. He believes centenarians live longer because their bodies are particularly resistant to the disorders that kill

How We Grow Old

The organs of the body suffer myriad indignities as we age, deteriorating in response to genetic signals and the wear and tear of daily life. Here's what we all can expect, if we live so long:

BRAIN

The cells start dying off in substantial numbers at around the age of 50; roughly half of all the people who live to be 85 or older suffer from dementia.

EYES

Vision declines between ages 40 and 50, after decades of exposure to sunlight. Macular degeneration, cataracts, and glaucoma can all cause blindness.

EARS

The structures in the ear that help with hearing and balance deteriorate over time, and we lose the ability to hear high-pitched tones.



at 72



at 88

So Yesterday

most people before age 90, such as cancer and heart disease. Perls calls this trait "selective survival," the vigorous ability to overcome health obstacles that defeat the majority of humans. And this ability appears to be heritable, because centenarians tend to cluster in families.

UNANSWERED QUESTIONS

A BROAD SWATH of researchers around the world are determined to ferret out the factors that confer this survival advantage. They are toiling in government labs, academic settings, and tiny startups, and have already figured out how to extend the lives of yeast, worms, flies, and ro-

dents by 30% to 40%. This requires new ways of thinking about some of the great unanswered questions in biology. If answers are found—if people can be reengineered to live routinely to be 110, or 120, or 150—it will have an impact on every aspect of society in ways that economists, health-care experts, and social scientists are only beginning to contemplate.

The pace of the research will probably outstrip that of policymakers trying to deal with its implications. Dr. Donald K. Ingram, head of the experimental gerontology lab at the National Institute on Aging (NIA), concedes it could be a decade or more before there is a fundamental

breakthrough on life extension, and there may be considerable risks in tampering with the aging process. Nevertheless, he says, "I think the discovery of some agent that would increase life span by 20 to 30 years is not unreasonable."

So far, such an agent is strictly hypothetical. The many potions hawked at "longevity clinics" and health-food stores are so ineffective that 51 renowned scientists published a manifesto in *Scientific American* debunking them. "No currently marketed intervention—none—has yet been proved to slow, stop, or reverse human aging, and some can be downright dangerous," they charged. "Anyone purporting to offer an anti-aging product today is either mistaken or lying."

It makes sense that there is no easy fix, because the aging process is enormously complex. Consequently, scientists are pursuing myriad ways to slow it down. Some are teasing out the dozen or more genes that can protect the body from the ravages of aging, while others are manip-

Number of sweat glands and nerve endings in the skin decreases around age 50, leaving the body more vulnerable to temperature variations.

BONES

Density decreases over time, and the effects of osteoporosis are especially debilitating for women. As bones age, they are increasingly prone to fractures.

MUSCLES

Atrophy of the muscles accelerates after the age of 80. The deterioration of leg muscles can leave people dependent on canes or wheelchairs.

LUNGS

After age 20, the lungs slowly lose air sacs. By old age, breathing becomes shallow, leaving the elderly more susceptible to pneumonia and other lung diseases.

HEART

The heart wall, valves, and arteries thicken and become stiffer with age, and there is less fluid in the bloodstream, raising the risk of arteriosclerosis.

BLADDER

The maximum volume of the bladder decreases, and the bladder muscles weaken. This can leave many elderly people prone to incontinence.

ulating hormones that do the same. Still other groups devote their time to figuring out how to delay the damage caused to cells by oxygen particles called free radicals, which essentially rust the body from the inside out.

Substances contained in blueberries, red wine, spinach, and other foods are all under investigation for possible life-extending properties. The most publicized approach, the effort to extend life through extreme calorie restriction, has even engendered cultlike groups around the world eagerly hoping to cheat the clock by sticking to near-starvation diets.

All of these efforts are part of the search for a fountain of youth that has been going on for at least 3,000 years (some of the earliest theories are documented in an Egyptian papyrus titled *Book for Transforming an Old Man into a Youth of Twentry*). But it wasn't until the past 100 years that most people could expect to reach even middle age. In 1900, the average life expectancy in the U. S. was 48; today, it is 80 for women and 75 for men. Virtually all of these gains can be attributed to improvements in public health and safety, such as clean water, refrigeration, seat belts, and routine vaccinations.

In recent years, advances against heart disease and cancer have extended life expectancy by a further seven years or so for the over-65 set. There is a finite number of years to be gained from curing disease,

“I think the discovery of some agent that would increase life spans by 20 to 30 years is not unreasonable”

—Dr. Donald K. Ingram,
National Institute on Aging

however. To get people routinely living well to 110 or 120, the aging process itself would have to be slowed.

This is no easy goal, because there is no single factor, such as a gene, that directly determines aging. The process is more of an evolutionary byproduct. Nature simply has no need for any organism to live beyond its reproductive age, plus whatever time it takes to raise its young. Once most living things pass their reproductive prime, their bodies fall apart. All the cellular processes needed to sustain life start to wear out, and organisms become slower, weaker, and more prone to disease. Humans, because they have no natural predators, are able to soldier on well past this particular sell-by date, as do household pets, but our parts eventually do break

down. Nevertheless, there is no biological switch that demands that life be terminated. We are not programmed to die.

The lack of a “death gene” has caused many scientists to speculate that there is no biological reason why humans cannot live to be 150. In reality, age is the greatest risk factor for mortality, because the aging process makes the body more susceptible to heart disease and cancer, the most common causes of death. This raises a knotty dilemma for longevity researchers. Should they try to delay the aging process itself or bolster the body's ability to ward off the diseases of aging?

Caloric restriction, for example, is an effort to slow down the aging process so that deadly diseases will strike much later in life. Researchers have found that worms, mice, and rats raised on diets with 30% or fewer calories than they would normally consume can live 30% to 40% longer than the average, and in better health. A subsistence diet seems to retard the aging process, allowing the animals to resist disease longer.

HUNGRY MONKEYS

SIMILAR EXPERIMENTS are under way with rhesus and squirrel monkeys by a team at the NIA and a team led by Richard A. Weindruch at the University of Wisconsin. These animals, which share most of their genome with humans, normally live from 24 to 40 years. So far, after 15 years on a restricted diet, the middle-aged primates have lower-than-expected levels of blood pressure and triglycerides and higher levels of health-protective hormones. Those readings indicate that the animals should be able to stave off heart disease, diabetes, and chronic diseases once they reach old age.

Few humans, however, could tolerate such a diet. The only monitored human experiment of caloric restriction was inadvertently conducted on the eight occupants of Biosphere 2 when they discovered their food supplies were much lower than expected. Dr. Roy L. Walford, one of the participants, reported that over two years on a diet of between 1,750 and 2,100 calories a day (the recommended daily allowance is 2,500), the occupants showed the same beneficial metabolic changes as long-lived rodents on calorie-restricted diets. However, the participants complained of feeling hungry all the time—causing one to wonder if centenarians on such a diet would find their longevity worth living.

Consequently, a number of scientists in the field of aging are searching for “calorie-restriction mimetics,” substances that



Seeking a Fountain of Youth

While there is no proof that life extension is possible in humans, scientists have succeeded in extending the lifespans of worms, fruit flies, and mice through these three approaches:

GENES

At least 15 different “longevity” genes have been manipulated to extend the life of organisms, including genes that control the production of insulin.

◆ Knocking some of these genes doubled the lifespan of worms and flies.

ANTIOXIDANTS

Cells are constantly under attack from free radicals, a byproduct of oxygenation. Scientists are trying to turn up the action of antioxidant enzymes.

◆ Increasing the activity of two antioxidants extended the lives of fruit flies by 1/3.

CALORIC RESTRICTION

Dramatically reducing an animal's daily calorie intake has been proved to retard the rate of aging in several species.

◆ Cutting daily calorie intake by 30% in mice extended their lifespan by 30%.

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Craig Venter



A pioneer in decoding the genomes of everything from microbes to humans, and president of The Center for the Advancement of Genomics.



What value does genomics have?

In health care, the value is going to come from preventive medicine. It can save governments and insurance companies huge amounts of money by preventing disease from happening rather than treating it when it occurs.

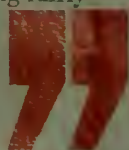
Where, outside of medicine, may genomics also play a big role?

I see much more potential economic impact from the nonmedical uses, such as the work we're doing with synthetic cells. It may be possible, for instance, to take the genetic pathway from the yew tree [the original source of cancer drug Taxol] and put it in the cell and have the cell do the complex chemistry. Such a cell could do complex manufacturing that chemists can't do—and open up a whole new repertoire of drugs.

If we get more theoretical, we could use [synthetic microbes] to take CO₂ [from the atmosphere] for the synthesis of pharmaceuticals, textiles, and other products. We could have synthetic cells that take energy from sunlight and convert it to clean fuels such as hydrogen. That will have an impact on everything from politics to the world economy.

Are these innovations likely to happen?

How likely they are depends on how much investment we as a society are going to make. Right now there is very little, except on the health side. But if we don't do something fairly substantial soon about the CO₂ we are adding to the atmosphere, then maybe curing cancer won't be of any value.



would trick the body into thinking it is on a drastically reduced diet. One of the most intriguing candidates was first identified in the lowly yeast. In 2000, Leonard P. Guarente, professor of biology at Massachusetts Institute of Technology, discovered that a yeast gene called SIR2 acts as a master switch, activating or shutting down parts of the genome based on how much energy is available.

When food is scarce, SIR2 slows down a yeast cell's energy-processing function to make sure it will survive to reproduce when conditions improve. Guarente's lab has found that yeast cells given an extra copy of the SIR2 gene live longer than normal, while those missing SIR2 have much shorter life spans.

FAT FIGHTER

GUARENTE'S LAB is focusing on a human gene equivalent to SIR2 called SIRT1, which evolved to protect cells from dying during times of famine. SIRT1 turns off the body's ability to store fat, using it for fuel instead—making the gene an important target for obesity research. SIRT1 could also explain the health benefits often attributed to red wine: resveratrol, a substance in the skin of grapes, has been found to activate the gene.

Guarente is involved in one of the few companies devoted to anti-aging research. In 1999, he and another leading researcher in the field, Cynthia Kenyon of the University of California at San Francisco, started Elixir Pharmaceuticals Inc., based in Cambridge, Mass. They were later joined by Perls, director of the Centenarian Study, as well as Louis Kunkel and Dr. Annibale Puca of Harvard Medical School. "We talked to a lot of people about commercializing our research, but Big Pharma is not ready to buy into the idea that there are central mechanisms underlying disease," says Guarente.

Elixir's stated mission is to find drugs that target the genes involved in the aging process. Guarente predicts such a drug could be available in 5 to 10 years, though he says it likely will be developed as an anti-obesity or diabetes treatment rather than an aging preventive—because it could take some 70 years of clinical trials to prove that aging can be delayed.

But even if genes can retard the rate of aging, the body must still contend with the stress of living. Every day, cells are attacked by free radicals, toxic oxidants created when oxygen, fats and carbohydrates combine to produce energy. These particles bombard each cell some 10,000 times a day. Over time, the attacks begin to wear the cells down, leaving them vul-

nerable to disease much the way rust weakens a car's structure. Many scientists believe that if some sort of biological anti-rusting agent could be found to protect against free radicals, the body would be able to fend off disease much longer.

That agent could be related to superoxide dismutase (SOD), an enzyme produced by the body to break down the most damaging free radicals. By turning up the activity of SOD and an accompanying enzyme called catalase, a number of experiments have extended the lifespan of fruit flies and worms by a third more than normal.

Significantly, researchers have not had the same luck with mice, raising some doubt about SOD's usefulness in mammals. Scientists at Oregon State University had better results when they fed old rats lipoic acid and acetyl carnitine, chemicals that are converted into antioxidants inside the cell. The rats regained agility, looked younger, and had better functioning brains and immune systems.

Blocking free radicals could cause some blowback, though. Gordon J. Lit-

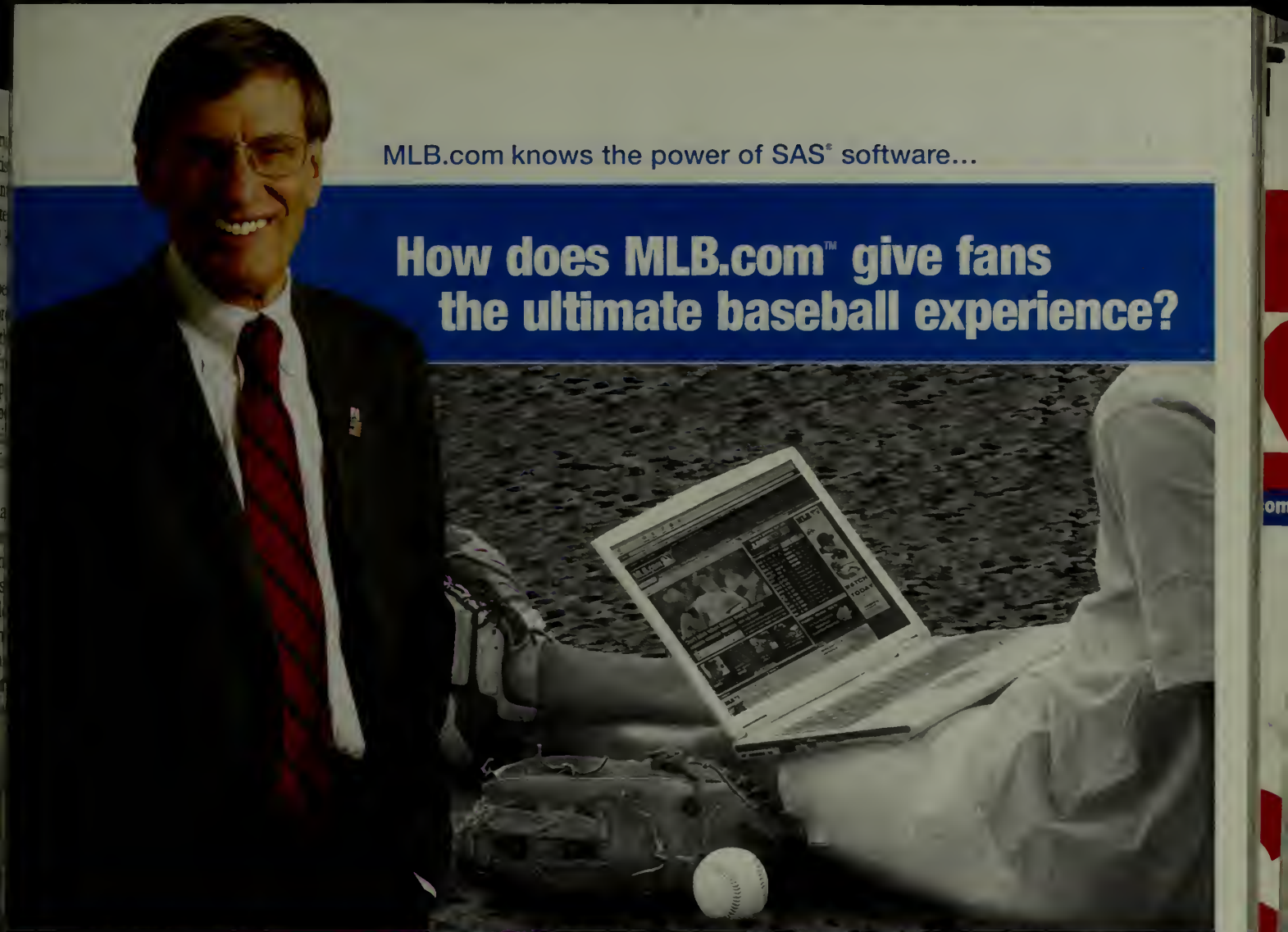
» Substances in blueberries, red wine, and spinach may well possess properties that extend life

gow, an associate professor at Buck Institute for Age Research, warns that "we need free radicals to protect against infection. By manipulating these genes, we may be introducing a fatal flaw."

There are, of course, some perfectly safe ways to extend life. If more humans lost weight, stopped smoking, exercised regularly, and drove carefully, the average lifespan could easily be extended a further 10 years. But just staggering through another decade wouldn't satisfy most people. As Litgow points out, "everyone wants another 10 years. But to be quite honest, it's not just the lifespan they want but a healthy longer life."

That desire ensures that anti-aging research will continue to flourish. Until it produces results, we might all want to start drinking port. ■

BusinessWeek online For a look at early commercial activity in the quest for longevity, please visit www.businessweek.com/75



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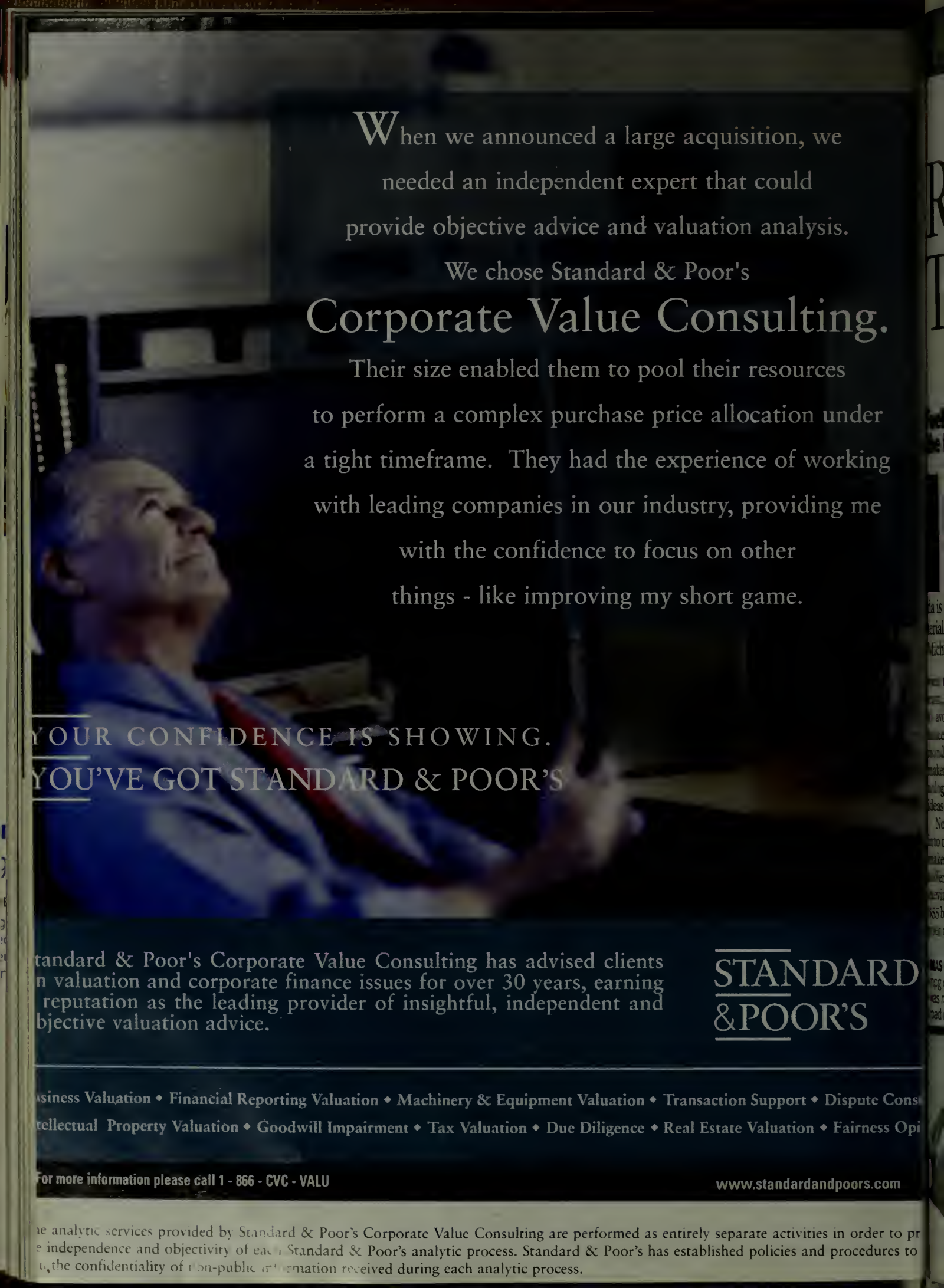
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Reinventing The Wheels

Fuel cells, crash-proof cars—auto makers are forging the future now. By David Welch and Chester Dawson

IN THINK TANKS AND ON TEST TRACKS from Tokyo to Motown to Munich, automotive technicians are brainstorming the future of the automobile. It's a fierce race, with companies like Toyota, General Motors, and BMW vying to lock up the latest in digital, imaging, and even biological technologies. "The field is so competitive that we'll visit a university and find out that GM was there yesterday and Honda is coming tomorrow," says Jeff Makarewicz, general manager for materials engineering at Toyota Motor Corp.'s technical center in Ann Arbor, Mich. **■** The goals of the big auto makers are certainly ambitious: They

want to break free from the grip of petroleum, develop cars that are smart enough to avoid accidents, and continually enhance the pleasure of motoring. Says Raymond Freymann, head of German automaker BMW's vehicle research and technology unit: "Our job is to translate crazy ideas into reality."

Not all the crazy ideas will make it into the showroom, of course. With carmakers locked in a brutal price war and suffering from massive overcapacity, it's inevitable that much of the industry's \$55 billion combined yearly R&D budget goes toward practical advances like new

model development. And car buyers faced with limited budgets may be inclined to choose a souped-up sound system over side air bags. That explains why some of the most impressive gadg-



HMAS Honda's 94-mpg concept vehicle was modeled after a road racing bicycle



ets are sold as optional equipment—and show up first in luxury vehicles.

Auto researchers face another constraint. Consumers are notoriously touchy about any new technology that comes between them and the driving experience. Seven years ago, a General Motors Corp.-led consortium conducted tests in which fully automated cars were driven over 8,000 miles on a span of highway outside San Diego. The whole thing came off without a hitch—except that passengers grouched that they wanted more control. The lesson? "We have to be very careful in introducing new technology not to make our customers' eyes spin," says Jon Bucci, a manager in Toyota's advanced technology department in Torrance, Calif.

Still, these are heady times for auto researchers. Here's a look at the most promising areas of innovation:

PROPULSION

THE BIGGEST CHALLENGE facing auto researchers is the one that has bedeviled the industry ever since the first Mideast oil shock of the early '70s: how to replace the internal-combustion engine. Researchers are working on three different approaches to solving the problem—fuel cells, engines that burn both hydrogen and gasoline, and hybrid gas-electric cars.

After years of false starts, some engineers believe they're getting close with fuel-cell propulsion systems. In theory, power is generated by pumping hydrogen through a series of plates, or stacks. They strip the hydrogen of its electrons and create a charge. That electricity is stored in batteries and used to power electric motors. There's no need to plug into an outlet, and the exhaust is water vapor.

This process could result in a total rethinking of car design, and not just under the hood. GM, which has spent more than \$1 billion on fuel cells, demonstrated

Automotive's Ahead

some of the most advanced technology when it built the stacks and batteries right into the floors of its AUTOnomy and Hy-wire concept cars. That gives their platforms a kind of skateboard look and frees up heaps of space. Hy-wire can hit 100 miles per hour on electricity generated by the fuel cells. What's more, there's enough power to control steering, braking, and acceleration with electronic controls instead of mechanical parts. So the fuel-cell vehicles are much lighter than today's cars.

But several hurdles must yet be cleared before fuel cells can take over. Where, for example, will the hydrogen come from? It can be produced in refineries, like gasoline, but energy companies won't invest in hydrogen refining until they see real demand. Then there are the challenges of storing hydrogen—it must be held in liquid form at -422F or under heavy pressure as a gas. Both processes require big, expensive tanks, and the act of managing temperature or pressure takes away some energy generated by the stacks. It's also unclear which companies would be willing to build a new network of hydrogen filling stations.

As a result, fuel-cell vehicles remain extremely costly. While Honda Motor Co. and Toyota currently lease a few dozen fuel-cell autos to municipal governments and academic institutions in the U.S. and Japan, industry officials estimate that these experimental cars cost more than \$1 million each to build. And Japanese auto execs aren't counting on selling them to the masses anytime soon. "I believe it's going to take 30 years until we see this technology being as common as today's technologies which are utilized by tens of millions of cars," says Takanobu Ito, president of Honda R&D Co.

GM is more optimistic. It hopes to have affordable fuel-cell-powered models on the road in the next decade. BMW, meanwhile, isn't very interested in fuel-cell technology right now. Instead, it is developing an engine that can burn hydrogen



HY-WIRE GM's concept car can hit 100 mph on fuel cells

or gasoline. The company has been investing in the technology since 1976 and now has a test fleet of 7 Series luxury sedans that are fitted out with engines that can switch at a driver's command between the two fuels. BMW's Freymann says that in three years or so, future 7 Series sedans will be equipped with the engines. A private-public consortium has already built a hydrogen filling station in Munich, and another will open in Berlin in November.

In the meantime, drivers conscious of the environment and fuel costs can buy a hybrid gas-electric car. These vehicles are suddenly popular, even though they cost \$3,000 to \$5,000 more than typical gas-powered autos. With waiting lists that can stretch for nine months in the U.S., Toyota recently announced it would boost production by 50% of its popular Prius sedan, which uses electric motors to assist gas engines. Honda is about to add a hybrid Accord and has produced such futuristic prototypes as the ultra-light-

weight, 94-mpg IMAS. A hybrid sport car concept with industry-leading aerodynamics, a shaftless drive-by-wire steering wheel, and side cameras, the IMAS was modeled after a road racing bicycle

SAFETY

POWERING THE CAR is key. But making sure it doesn't crash is another preoccupation of auto makers these days. The big players are focusing on two kinds of technologies: safety devices to detect and avoid possible collisions, and navigational advances to help cars stay out of traffic jams and find their destinations more easily.

Imagine a car that's smart enough to avoid fender benders—or back itself into that tight parking space at the supermarket (page 156). As digital cameras, radar, and navigational devices become less expensive and more reliable, researchers are looking for ways to incorporate them into systems that detect objects in blind spots and avoid collisions. Toyota plans to offer rear-mounted cameras in all its cars as i

The Road Ahead

Here are some of the most promising technologies under development in auto research labs:

FUEL CELLS

The great hope of General Motors and some other carmakers is that they can harness the power of hydrogen with fuel-cell stacks, powering cars with electricity and eliminating tailpipe emissions.

Prospect: The most optimistic estimates say this technology is at least 10 years away from the mass market.

COLLISION AVOIDANCE

Radars, cameras, and computers work to keep you within the white lines or hit the brakes when you're about to hit something.

Prospect: "Passive" accident-warning systems are in use by BMW, Lexus, and Mercedes. More active systems are showing up in Japan, but U.S. versions are a ways off.

DRIVER INFORMATION

Sensors in cars or on the roads can warn about problems under the hood or traffic jams and point you to a repair shop or an open lane.

Prospect: GM's OnStar and other systems already provide navigation. Honda is working on a traffic-information system, and BMW is working to have cars pass road information to each other.

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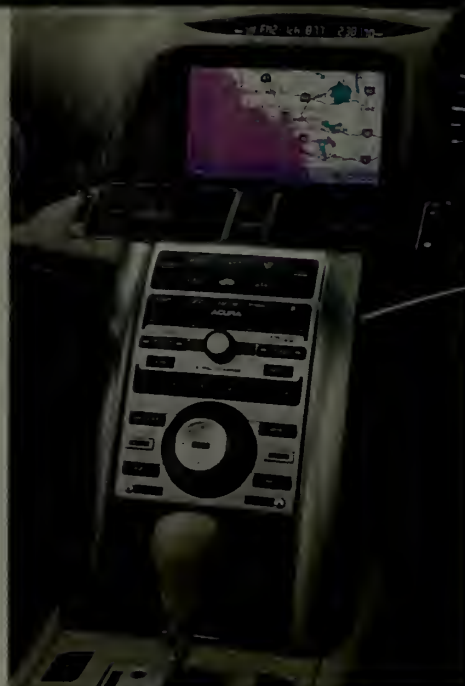


upgrades its lineup. Earlier this year, the company rolled out a system in its top-of-the-line Lexus 430 that warns drivers if their car is too close to the vehicle ahead. Ford Motor Co. has a prototype Mustang outfitted with a similar system.

Honda took the technology a step further. Starting in Japan last June, the company offered a system on its Inspire compact that uses buzzers and lights on the instrument panel to warn drivers of possible danger. If the warnings are ignored, the car will take up the slack on seat belts and then proceed to apply the brakes slightly. If that doesn't work, the vehicle is programmed to tighten up the seat belts and brake firmly—though not so sharply as to stop dead in its tracks. Similar devices are being employed to fight driver fatigue.

This fall, Nissan Motor Co. will be the first auto maker in the U.S. to offer yet another twist on collision avoidance—lane-keeping technology. A small front-mounted camera detects when a car starts drifting from a lane without a turn signal and beeps a warning to the driver. While this technology has been available for years in Japan, the system—developed by Anaheim (Calif.)-based Iteris Inc. and France's Valeo—had to be improved before its introduction to the U.S. to account for a wider variety of road conditions. It will be offered as an option in the Infiniti FX45 SUV.

Of course, the best way to avoid collisions is to stay out of busy traffic. Honda's new Acura RL luxury sedan, which goes on sale this fall, will be the first U.S. model equipped with a computer navigation



SMARTY Acura's RL sedan, which rolls out this fall, tracks live traffic flows, warns of traffic jams, and receives e-mail updates from dealers

system that tracks live traffic flows on screen and flags bottlenecks caused by accidents or construction. The version Honda developed jointly for the U.S. with XM Satellite Radio Holdings Inc. of Washington, D.C., uses satellites to cover more than 20 cities. Honda also equipped the RL with telematics that allow dealers to send audio or text e-mails about maintenance issues directly to customers' cars via satellite.

COMFORT

ALL THESE ADVANCEMENTS stand a chance of making cars more fuel-efficient and the roads safer. Still, for many drivers and their passengers, nothing is

more important than how they feel inside their car—the driving experience itself. With the dramatic expansion of the luxury-car market in recent years, brands are under increasing pressure to add the kinds of creature comforts that distinguish a \$40,000 car from one selling for half that.

Pay a visit to the suburban Detroit design studio of Lear Corp., one of the biggest suppliers of car cabins in the world. Here, young designers work with materials as exotic as bamboo and Ecuadorian Tagua nuts to create distinctive car interiors for tomorrow's luxury cars. Other auto makers are trying to make the car a more accommodating living space. Mazda Motor Corp.'s new Verisa compact car, sold only in Japan, features a mini-dressing table that folds out from the glove compartment—complete with makeup mirror and lamp.

Of course, these enhancements aren't as much technological as design innovations. But they still sell cars. With global competition growing tougher all the time, drivers can look forward to further developments in the race to reinvent the automobile. ■

—With Gail Edmondson in Munich and Ian Rowley in Utsunomiya, Japan

In a Tight Spot—and Loving It

Ever wish your car could just squeeze itself into a tight parking spot? In Japan, it can. Toyota Motor Corp. offers a self-parking feature on its Prius sedan sold there. And engineers at Toyota's technical center in Ann Arbor, Mich., recently demonstrated an English-language version.

Here's how it works: First, shift the car into reverse. Automatically, a dashboard-mounted screen shows a clear view of your parking space—thanks to a camera mounted on the vehicle's rear hatch. Touch either a "parallel" or "back in" button and an icon will appear above a series of eight directional keys and two rotational buttons overlaid on the video screen. Using those keys, line up the icon straight against the bumper of the nearest car. Once that's done, push the "set" button, and voila! The car nudges itself into the space, as you keep a foot on the brake and your

hands off the steering wheel. A bright red grid on the video monitor shows how far to go before applying the brakes.

But don't get too excited. Just backing in to a spot takes about two minutes—considerably longer than a confident driver might take to do the job alone. And if the spot is too narrow, the system isn't programmed to sound a warning or stop itself from scratching the BMW and Mercedes-Benz parked on either side of you.

Those are two good reasons Toyota so far hasn't tried selling the system, part of a \$2,000 package of options, to American drivers. Most important, it worries about the lawsuits that might result from an accident. But with technicians working on a next-generation system that they say will eliminate much of the fuss, Toyota's innovation may yet become a hit for those with a fear of parallel parking.

—By Chester Dawson in Ann Arbor, Mich.



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How Will TV Survive Its Own Reality Show?

To thrive in the Internet Age, the industry must remake itself. By Ronald Grover

THE TELEVISION WORLD USED TO BE so simple. When onetime suspender salesman Ralph Roberts started what would become cable giant Comcast Corp. 41 years ago in Tupelo, Miss., it was a just matter of stringing up wires. Surely folks would come to him, eager to get crystal-clear signals from the Big Three—CBS, NBC, and ABC. But for CEO Brian Roberts, who has taken over from his father, competition is everywhere today, from satellites to phone companies. More than rivals, though, the biggest challenge for Roberts and every media executive is something bigger: consumers empowered as never before.

In fact, TV is confronting the biggest turning point in its more than 60-year history. The most profound change under way is one of technological upheaval. Digitization and high-speed data lines are giving viewers unprecedented control over what they view and when they view it. That's because programming has become less and less tethered to a particular device, threatening the extinction of the old square box. It also means that prime time will certainly evaporate, so that new revenue models will come to replace the traditional 30-second spot ad as the lifeblood of the industry. "The world is going to change whether we like it or not," says David Westin, president of ABC News, which in July began delivering the new 24-

hour ABC News Now service to cell phones and the Internet. Phones and a computer? How would legendary CBS founder William S. Paley get his head around that idea?

Once upon a time, viewers got comfy front of the boob tube. Today they are armed with time-shifting and personalized devices that zap ads—such as digital video recorders, Internet connections and even cell phones that can order up the latest *Hardball* show on MSNBC. They can watch *Monday Night Football* on Thursday and *Everybody Loves Raymond* whenever. Sanford Bernstein media analyst and former NBC exec Tom Wolzien calls this the "great decoupling" between TV content and how it is delivered. In what he calls the "Internet bypass," Wolzien sees the rise of broadband leading to even more experimentation with the way shows are distributed. Indeed, as he grapples with his place in this new world, Robert C. Wright, chairman of NBC Universal, now talks about being a content provider that is "platform neutral."

They're all figuring out how to give liberated customers more choices. Comcast Roberts has set out to give viewers what amounts to a huge video store in their living rooms. On Sept. 14, he agreed to an up to \$300 million to help Sony buy the MGM studio so that it could tap MGM's 4,000-film library. And Wright pushed parent General Electric Co. to approve NBC's merger with Vivendi Universal to be able to offer Universal's vast library of programming across many outlets.

To better understand what consumers will want in this new age, TV honchos are intensifying their research. Three years ago, CBS built its Television City Research Center, a 5,000-square-foot facility in the MGM Grand Casino in Las Vegas. The move made perfect sense, say CBS executives, since the 36 million visitors a year to the

LAS VEGAS
At CBS' research center, affluent audiences rate new shows



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FOREWORD BY TOM PETERS

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gambling mecca, from high rollers to sunburned families from Arkansas, offer up the ideal test audience. They are mostly being tapped to render opinions on new shows but increasingly are helping the network study all kinds of trends—how people use personal video recorders, for example, or how viewers respond to products placed in shows. "We get folks . . . who are generally more upscale and younger than the population at large," says CBS chief researcher David Poltrack. "Those are our kind of people."

Now, as new technology revolutionizes the distribution of shows, and the networks lose their iron grip, they'll need to figure out new ways to make money. The old model, built on the 30-second spot that fetched a premium at prime time, still delivers \$19 billion a year to the networks. But no one feels secure about the future as the mass market splinters. So some are testing alternative revenue streams. Beefing up subscriber fees is one tack: Last year, Fox test-marketed a cable fee of \$19.95 a month to see recent episodes of its hit show *24* on demand. HBO subscribers on Time Warner Inc.'s cable systems can pay an added \$6.95 a month to catch *The Sopranos* and *Six Feet Under* episodes they missed. Comcast offers replays of the *NBC Nightly News* free with a digital subscription and may do the same with MGM movies. A small business now, video-on-demand may hit pay dirt by 2009 when it becomes available in 44 million U.S. homes, figures Josh Bernoff of Forrester Research Inc.

PRODUCTS ON PARADE

PERHAPS THE BIGGEST challenges for TV execs are ad-skipping digital video recorders such as TiVo. With satellite and cable operators pushing DVRs, as much as 20% of the country will have them by 2008, estimates PricewaterhouseCoopers. And 70% of the DVR users will fast forward through ads, says Forrester. To combat that, networks are loading up programs with product placements: Doritos for contestants on CBS's *Survivor* and AT&T phones used for call-in voting on Fox's *American Idol*.

The proliferating platforms, however, may turn out to be less threatening and more lucrative than execs think. TV outlets such as NBC News, Fox Sports, and ABC News are already finding new revenue by licensing shows to Sprint PCS Group phones. Handheld devices powered by Microsoft software will soon be able to deliver programs much as music is available for download today. "It really is a way to make existing program-

The TV of Tomorrow

» The media landscape is changing rapidly, so network executives are reconsidering how TV has to evolve. Here's a glimpse of what television might be like in 10 years:

NO LONGER A BOOB TUBE

The box with wires coming out of it will be just one way folks will see TV programs. Cell phones, PDAs, and computers will also receive shows. The way shows are delivered will be less important.

BRANDMEISTERS

Building shows into major brands will become even more important across all lines of distribution, from TV to toys. TV execs will begin to look and act more like brand managers at consumer-product giants such as P&G.

NO MORE B-GRADE SHOWS

Greater storage capacity to hold old shows and movies within set-top boxes and personal video recorders will make it harder for TV execs to sell new shows, since fine old stuff is an attractive alternative. New shows of mediocre quality will bite the dust sooner.

LIVE ON ARRIVAL

The best way to counter the allure of time-sharing on personal video recorders is to air compelling live shows. You'll see more programs in real time.

Data: BusinessWeek

ming go a longer way," says Larry Gerbrandt, head of the media practice consultant AlixPartners.

Although broadband speeds are still too slow to show TV in real time, networks are preparing for the day when the Net is a viable alternative. CBS airs daily Internet talk show about its *E! Brother* show. ESPN went a step further when it streamed its Pete Rose movie *Hustle* on the Net two days before Sept. 25 TV debut.

TV execs like to downplay what is going on in their business by saying it's not a revolution, but rather evolution. Either way, the TV world is anything but the uncomplicated place it was when Ralph Roberts started out more than four decades ago. ■

BusinessWeek



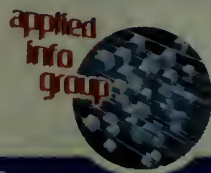
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THE INNOVATION ECONOMY

Global



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The booming town of Shenzhen
China, where Huawei is based

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Hot Spots

An Old Hotbed with New Crops

This time around, the Valley is nurturing startups that combine info tech with emerging technologies. By Jim Kerstetter

FOR NEARLY 50 YEARS, Silicon Valley has been a marvel of reinvention through innovation. Every decade or so, a new generation of companies has come along to spark the local economy. After the granddaddies of the Valley's high-tech industry, such as Hewlett-Packard and Fairchild Semiconductor International, there were Intel and Apple Computer in the wild early days of the personal computer. Then computer networks became de rigueur in corporations, and Cisco Systems, Oracle, and Sun Microsystems rose to prominence. In the 1990s, Netscape Communications Corp. cooked up a spiffy Web browser and started the Internet revolution. Even today, years after the dot-com bubble burst, Valley Net companies like Yahoo!, Google, and eBay are changing the way people do business.

But along the 45-mile stretch of Highway 101 from San Francisco to San Jose, there's a nagging question these days: What's next? The anxiety is fueled by the employment picture. The number of jobs in the region has plummeted 20% since 2001, to 840,000, the steepest loss since the Valley's fortunes were fashioned from silicon. The tech industry's prospects offer little comfort. While some analysts believe the information-technology industry can resume growing at its historical average of nearly 10% annually, others see it languishing at only 3% to 5% annually for the foreseeable future. That's the kind of growth expected from Rust Belt

businesses, like the automotive industry.

Is Silicon Valley becoming the digital Detroit? Or can it reinvent itself one more time? Look closely and you'll see that the process is already beginning. University labs are bubbling with unorthodox ideas. Entrepreneurs are building startups of a different species than traditional high-tech companies. And venture capital is following. The Valley's best and brightest are heading off in new directions, blending info tech with biotech and emerging material sciences such as nanotechnology. This cross-pollination is producing hybrid companies that will play a critical role in the region's efforts to remain the

center of gravity for innovation. "The key is to look in the white spaces between disciplines," says John Seely Brown, the former head of the famed Xerox Corp. Palo Alto Research Center and now a visiting scholar at the University of Southern California's Annenberg Center for Communication.

Think of this as Silicon Valley: Next Generation. A new crop of startups offers a peek into the future. XDx Inc., in South San Francisco, Calif., is using information technology to improve the monitoring of heart-transplant patients' immune systems. Silicon Genetics, based in Redwood City, Calif., has developed software tools to make it easier to research human genetics. And Santa Clara's Peribit Networks Inc. is applying biological research to data networking.

LURE OF INDIA

THE VALLEY'S STARTUPS aren't being built in the same old ways, either. Increasingly, they're hiring many of their employees elsewhere—often overseas. Two Valley venture firms, JumpStart! Fund Advisors and WestBridge Capital Partners LLC, even specialize in so-called cross-border startups that split their staffs between India and the V



R&D Scott's
Stanford program
will let experts
from different
fields cooperate

ley. The top execs, along with the sales and marketing staffs, typically are in the States, to be close to customers, while the engineering staff, including most of research and development, is in India. "Over the next five years, there are going to be quite a few of these companies funded," says M.R. Rangaswami, co-founder of Sand Hill Group, a Valley-based consulting company specializing in Indian business.

The new regime in Silicon Valley means this round of reinvention won't be anything like those of the past. In particular, there's unlikely to be the kind of job growth that followed the personal-computer and Internet booms. The cost of living in the Valley is now so prohibitive that cash-strapped startups can't afford to hire many people here at the salaries they need. The median price of a single-family home has shot up 240% over the last nine years, to \$640,000. The result: Only 21% of the people who live in Silicon Valley now earn the median income necessary to

» A rich research heritage, a good climate, and plenty of venture capital add up to a growth engine that won't shut down

buy a house, down from 36% in 1995, according to Leslie Appleton-Young, chief economist at the California Association of Realtors. That's one reason why the Valley is expected to see just 1% to 2% growth in employment for the next several years, according to Economy.com.

Still, there's little question that the Valley will continue to create important, innovative companies. The region has been

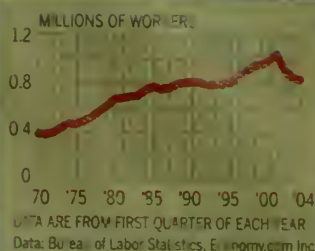
blessed with a rare combination of venture capital, good weather, and institutions such as Stanford University and University of California at Berkeley that are loaded with academic and research talent. Most of all, the Valley has fostered a culture of risk-taking, where talented hotshots itch to turn great ideas into corporate winners. This ethos is alive and well in the Valley and continues to draw ambitious entrepreneurs from far and wide. "We have a habitat for new companies here that's unique," says William Miller, a professor emeritus at Stanford and the former chief executive at SRI International. "All the services are here, and they all specialize in dealing with startups—the banks, the lawyers, the marketing firms. It all permits a company to move more quickly and get good advice."

And don't discount the value of more mountains and mountains of it. Venture capital, so important to nourishing ideas of young entrepreneurs, is still Valley-centric, with its epicenter along P

Booms ... And the Occasional Bust

» Silicon Valley's business cycles are tied closely to innovation in the computer industry. After the historic boom of the late 1990s, it's not clear what the Next Big Thing will be to get the Valley growing again.

EMPLOYMENT IN SILICON VALLEY



1968 – Semiconductor giant Intel is founded by Gordon Moore and Robert Noyce, two employees of tech pioneer Fairchild Semiconductor. Intel, under the leadership of Moore, Noyce, and Andrew Grove, becomes the model for Silicon Valley's egalitarian engineering culture.

1976 – Apple Computer is founded by Stephen Wozniak and Steven Jobs, beginning the personal-computer boom. Over the next nine years, the Valley's workforce increases by more than 60%.

1977 – Database software maker Oracle is founded by Lawrence Ellison, Robert Miner, and Edward Oates.

1981 – IBM selects Intel's computer chips for its new PC. Intel, which had focused more on data storage, shifts to making microprocessors for the growing PC market.

1982 – Corporate computer maker Sun Microsystems is founded by Scott McNealy, Vinod Khosla, William Joy, and Andreas Bechtolsheim.

1984 – Apple releases its initial Macintosh, the first affordable computer that allows people to use a mouse to click on icons instead of typing complex



computer commands.

1986 – The PC business begins to consolidate around a handful of manufacturers, and the Valley loses 3% of its jobs in one year. Lacking a major new innovation, the Valley's growth stays slow for the next eight years.

1991 – The Cold War ends, and the Valley loses nearly 3% of its jobs over the next year because of cuts to defense spending that hurt big contractors such as Lockheed and United Technologies. Employment bottoms at 790,300 in March, 1992.

1994 – Netscape Communications Corp. is founded by James Clark and Marc Andreessen. Netscape popularizes the Web browser and starts the commercialization of the Internet.

1995 – Netscape goes public, igniting the dot-com boom. In five years, the Valley's workforce increases nearly 30%. Employment peaks in December 2000, at just over 1 million jobs in Greater San Jose.

2000 – The boom ends. Over the next three years, the Valley loses 212,900 jobs. By July, 2004, total employment is 841,000 jobs, just 4% greater than at the beginning of 1995.

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Alto's famed Sand Hill Road. About 38% of the venture funding in the U.S. in the second quarter of 2004 went to companies in the Valley. That's twice the share of the runner-up, Boston, and almost exactly the same rate as it was 10 or 15 years ago. "It's very difficult to find an area where there's more brewing, at least for a U.S. investor," says Michael Moritz, a partner at the venture-capital firm Sequoia Capital.

Even so, the Valley must contend with the likelihood that it won't be the world's singular nexus for the funding and development of innovation. Silicon Valley's share of biotech spending in the second

quarter, for instance, was 29%, just seven percentage points ahead of Boston. "There was a time when venture capitalists cared about where they were investing," says Daniel Primack, editor-at-large at *Venture Capital Journal*, part of the research firm Thomson Financial Venture Economics. "But venture capitalists are looking everywhere for deals now."

They have to. Critical masses of talent are forming far outside the Valley's borders. Bangalore, India, and several regions in China, for instance, are emerging as important centers for software development, tech services, and low-cost manufacturing. These high-tech workforces

are beginning to create their own entrepreneurs, and both financiers and hi-tech companies are taking notice. "Innovation's still bubbling in Silicon Valley," says Shane V. Robison, chief strategy and technology officer at Hewlett-Packard Co. "I think it always will. It isn't the only place that it's happening."

EUREKA MOMENTS

THE MOST SUCCESSFUL startups may be those with one foot firmly planted in info tech and the other in emerging technologies. Peribit Networks is one such hybrid of the Valley's past and future. The Santa Clara company was founded in 2000 by a Stanford doctoral student, Amit P. Singh, who was doing bioinformatics research, designing algorithms and computational models to speed the analysis of DNA sequences by recognizing hidden patterns. When Singh finished his PhD, he was wondering what to do next. His "eureka" moment came when he realized his work could be applied to routing computer traffic on networks. "They took technology designed for the genetics world and moved it into the communications world," says David Ladd, a general partner at Menlo Park, one of Peribit's investors.

At Singh's alma mater, they're trying to make those breakthroughs a lot more common. Stanford opened the 146,000-square-foot James H. Clark Center in October, 2003, to provide a place where experts in info tech, biotech, and material sciences can share ideas and just maybe, spark a few business plans. The space-age-looking center, part of Stanford's interdisciplinary bioscience program called Bio-X, will house 60 entrepreneurs and researchers when it reaches capacity. The school is providing two-year, \$150,000 grants for people who want to do interdisciplinary research. "The health of the Valley depends on really new things coming along," says Matthew P. Scott, a cancer researcher and biologist who heads the Bio-X program.

The Stanford research center also has an eye toward the business community. About 10% of the spaces in the center will be reserved for visiting academics and people in private industry. Scott knows that whatever comes out of the Clark Center, or similar centers being built at nearby University of California campuses in San Francisco, Berkeley, and Santa Cruz, won't turn into big companies overnight. But he has an eye for the long term. "The growth of the Valley has been driven by a small number

Silicon Valley's Strengths and Weaknesses

The Valley continues to be a world leader in technological innovation. But behind every attribute of the local economy, there's also a downside.

PLENTY OF TALENTED WORKERS...

More than 30 years of high-technology entrepreneurs have created a strong workforce of engineers, tech marketing experts, venture capitalists, and legal experts necessary to get small companies off the ground.

AS LEADERS PLAN FOR FUTURE GROWTH...

Through groups like the Silicon Valley Joint Task Force, local business, government, and academic leaders are planning for the Next Big Thing, which could come out of the convergence of info tech, biotech, and material sciences. The Bio-X Center at Stanford University was created for the study of such convergence, and similar research centers are opening in University of California campuses in nearby San Francisco, Berkeley, and Santa Cruz.

VENTURE CAPITALISTS PREFER SILICON VALLEY...

Silicon Valley is still the biggest recipient of venture-capital spending. In the second quarter, \$2.13 billion in VC money was invested in Silicon Valley companies, more than twice the next highest recipient, Boston, and 38.2% of all the VC money invested in the U.S.

... BUT THE COST OF LIVING IS SCARY

The Valley's 6.2% unemployment rate is still above the 5.5% U.S. figure. One reason why is that wages have to match the out-of-sight local cost of living. The median price for a single-family home in the Valley is \$640,000, more than three times the national figure.

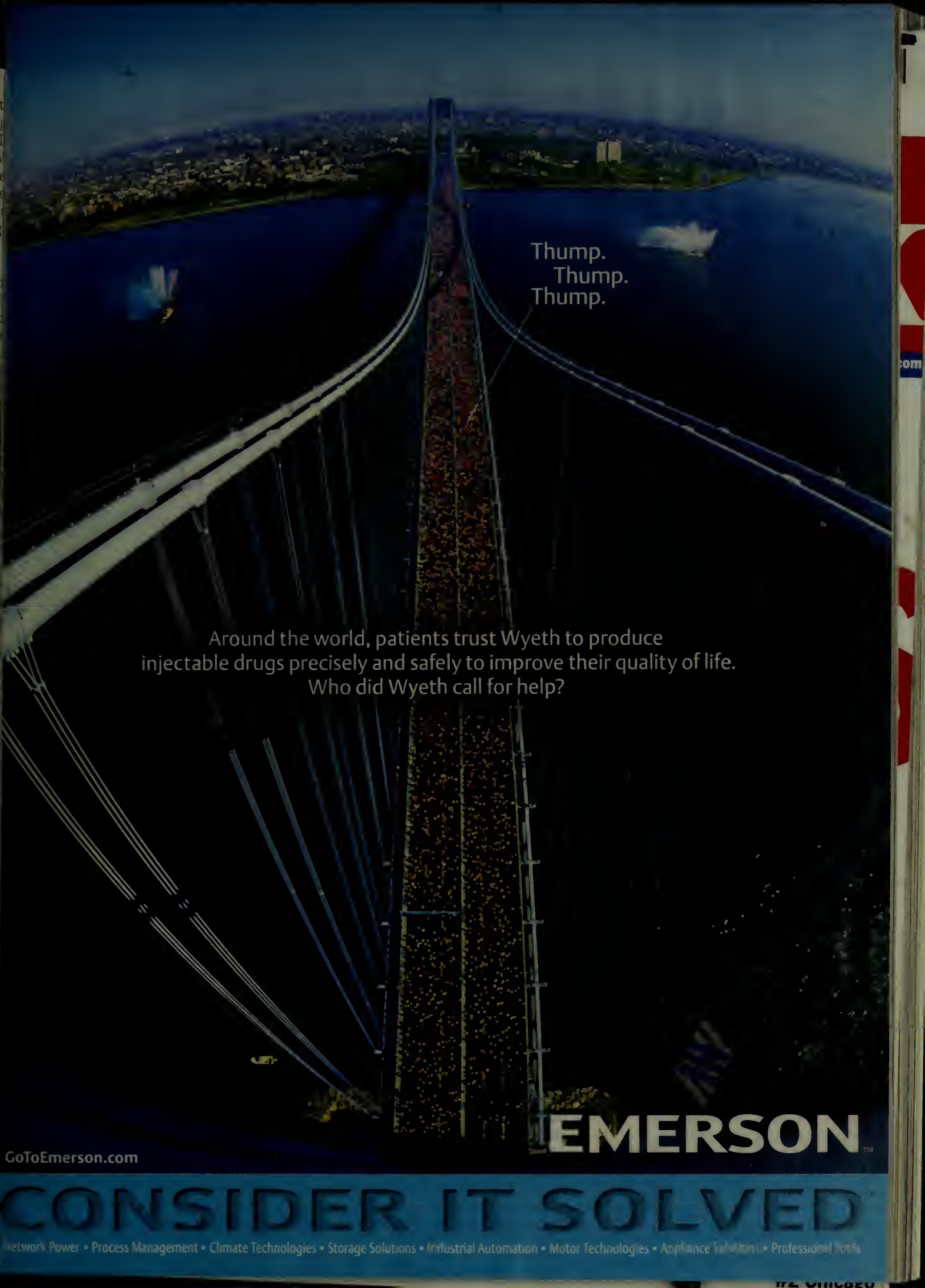
...BUT THEY WORRY ABOUT THE LOCAL INFRASTRUCTURE

Local leaders worry that a lack of affordable housing, cuts to the public school system, a poor mass-transit system, and a crumbling road infrastructure will limit Silicon Valley's ability to grow. Indeed, commuters on all bridges over San Francisco Bay may have to pick up the tab for an overbudget earthquake retrofitting project on the Bay Bridge, which connects San Francisco to Oakland. That project alone could end up costing more than \$5.1 billion.

...BUT IN BIOTECH, THE GAP IS CLOSING

Silicon Valley's share of biotechnology venture capital was 29% of the total spent around the U.S. in the second quarter. By comparison, Boston received 22%. Clearly, the Valley's grip on biotech spending isn't as strong as it is in traditional technology sectors.

Source: Venture Capital Economics; U.S. Census Bureau; California Association of Realtors; U.S. Bureau of Labor Statistics



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Roger McNamee



An innovator in venture-capital investing and co-founder of the Silver Lake Partners and Elevation Partners funds.

“What’s your prognosis for Silicon Valley right now? Silicon Valley got banged up badly, but has come back very strong. The Valley remains the world’s preeminent entrepreneurial community, and its relative advantage is greater than it was at the peak of the bubble.

What companies intrigue you now? Think about the coolest companies in our economy: Google, Yahoo!, eBay, Apple Computer, Electronic Arts, Pixar, PDI/DreamWorks. Silicon Valley has long been a hotbed for semiconductors and computers, but now it’s also a big player in media.

What about technology for businesses? We are between waves of enterprise technology. There are some interesting things percolating, but they are less apparent than the innovations in consumer technology. The next big wave will come in Web services. It will take a few years to get the technology right, though.

By the way, the venture community still has too much capital to invest, so money is going to areas that scare me. Nanotechnology and electric power technology are two examples. From where I sit, both offer more risk than return, at least in the near term.

Does it concern you that foreign graduate students can’t come to the U.S. or are staying away? Our immigration policy took a giant step backward because of fears associated with September 11. Making it hard for graduate students to come here does not make America safer. It makes us weaker.

very powerful technologies that utterly transformed the world. But these are outgrowths of technologies that have been developing for many, many years,” he says. The original programming protocols for the Internet, for example, were developed 26 years before Netscape went public.

While such initiatives could pay dividends down the road, some startups are going it alone. In a warehouse district of Redwood City, sandwiched into a row of auto yards, is Silicon Genetics. The company’s programmers and genetics experts are working on software tools that make it easier to make sense of the volumes of data unearthed in human genome research. It was founded by Andrew Conway, a biochemistry researcher at Stanford. Conway grew frustrated with the lack of good tools to help him do his job. So he built his own and created a company to sell it with about \$100,000 he made playing the stock market. “That is what you do around here,” laughs Conway, a 34-year-old Australian who came to California for graduate school.

It’s little companies like Silicon Genetics that are necessary to breath life into the Valley and its more mature companies. On Aug. 23, Agilent Technologies Inc., the tech-equipment giant that was Hewlett-Packard’s original instrument and measuring business before it was spun off in 1999, acquired the five-year-old company and its 50 employees for an undisclosed sum. Palo Alto-based Agilent plans to add Silicon Genetics’ two main software products to its growing portfolio of biomedical research software. The room full of programmers and PhDs will be moving out of the little office and getting new digs with the rest of Agilent by early next year. Agilent is turning to a startup to help it reinvent itself around genomics research.

Reinvention takes time, however. And some wonder if the Valley has the patience to wait for those new things. Valley investors are especially wary of biotech and materials research companies because of the inconsistency of the payoff. Roger McNamee, for example, the co-founder of Silver Lake Partners, prefers to

steer clear of biotech. “The capital intensity is very high, and the probability of success is very low,” he says.

A LITTLE HERE, A LITTLE THERE STILL, MANY ENTREPRENEURS are forming companies in innovative ways that don’t require as much capital as was needed before. Some are opting for offshoring jobs from day one. Take Conformia Software Inc. Based in Redwood City, the three-year-old software company has about 30 employees in Silicon Valley, including the executive team, marketing and sales. An additional 50 to 75 employees are in Bangalore, including nearly all of Conformia’s engineering. “When you’re a startup and you’re trying to conserve capital, it makes sense,” says co-



CONWAY Agilent recently swallowed his software startup

founder Neil K. Kataria. It’s the new Valley startup model: Keep your top engineers, sales, and marketing

people local. If other jobs can be done elsewhere for less, send them there. Of course, that won’t lead to a lot of new jobs for the local folks. But as long as Stanford and Berkeley have creative students, as long as San Jose averages 300 days of sunshine per year, and as long as the venture-capital community pours dollars into local startups, the Valley should continue to lead the world in joining invention with a business plan—the most tangible definition of innovation. From a region so accustomed to reinventing itself, the world should expect nothing less. ■

—With Robert D. Hof in San Mateo, Calif., and Bruce Einhorn in Hong Kong

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FIXING CATARACTS
Assembly-line surgery brings the price down



Getting The Best To the Masses

A wave of innovation is yielding high-quality goods that India's poor can afford. By Manjeet Kripalani

AT THE TATA MOTOR factory just outside Pune, south of Bombay, a group of young designers, technicians, and marketers pore over drawings and examine samples of steel and composite plastics. By early next year, they plan to design a prototype for Tata Group's most ambitious project yet: a compact car that will sell for \$2,200. The company hopes the car will beat out Suzuki's \$5,000 Maruti compact to become India's cheapest car—and an export model for the rest of the developing world. “This is the need of the day in India—

a people's car,” says Ratan Tata, chairman of the \$12.5 billion Tata Group. The car is expected to hit the market by 2008.

Investors, executives, and workers in the developed world have all felt the impact of India's booming software sector and call centers. But those are examples of Indians providing solutions for rich nations. Now Indian entrepreneurs and companies such as Tata Group want to provide products and services to the nation's masses. With 1 billion people, 70% of whom are poor, India needs low-cost, high-quality goods and services. Most Western output is too expensive or complex for the Indian market.

India's engineers and professionals are focusing on finding fresh solutions in fields from manufacturing and health care to finance and education. They're not only making use of the country's cheap labor and materials but also finding practical ways to get the job done on a mass scale. Says Vivek Paul, chief executive of software services giant Wipro Technologies, the world's largest supplier of outsourced research: “Thanks to the lowered cost of R&D now possible out of India, there are new avenues opening up that weren't possible before.”

MASSIVE CLOUT

THIS QUEST FOR THE BEST for the least could amplify India's impact on the global economy. “Future innovations will flow from the rise of capital-scarce but labor-abundant nations like India and China,” says Diana Farrell, director of San Francisco's McKinsey Global Institute. Already, Indian companies are eyeing markets in Asia, the Middle East, Africa and Latin America.

It remains to be seen, of course, how



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many of these goods and services find their place in Europe and the U.S. But thanks to increasingly demanding and sophisticated consumers, low-cost innovations have begun to spread across India, capturing the attention of analysts such as McKinsey's Farrell and University of Michigan business guru C.K. Prahalad. He is author of *The Fortune at the Bottom of the Pyramid: Eradicating Poverty Through Profits*, which focuses on inexpensive goods and services created in India, Brazil, and elsewhere.

Tata is the best example of Corporate India getting involved in these innovations. Tata has already developed the Indica, a compact hatchback that retails for \$6,600 and is exported to Europe. In the process, Tata engineers figured out how to use the skilled but cheap local labor instead of the industrial robots that would have been used in Japan or the U.S. on a car like the Indica. That decision shaved roughly \$1 billion off the design and production cost. As a result, the Indica can break even on an output of 80,000 vehicles—about 30% less than the volume

» By using cheap local labor for the Indica compact car—and avoiding industrial robots—Tata engineers shaved \$1 billion off production costs

that global auto companies need to profit from such a car.

The \$2,200 Tata compact—which will appeal to the 5 million Indians who own motorbikes but can't afford the standard economy car—pushes the envelope on cost even further than the Indica. Tata's specialists are also designing a new business model. If all goes according to plan, the new Tata car will be made and distributed not only from the Pune factory but also in knocked-down kits to franchisees across the country. The franchisees will assemble the new auto in mini-factories, as well as sell it, creating thousands of local jobs. That will save Tata millions—it's easier to ship kits than fully loaded cars—and the savings will show up in the car's low price. "Tata has the expertise to deliver such a

mass market product," says Kumar Bhatnagaryya, director of Warwick Manufacturing Group, the British auto think tank who has seen early versions of the new Tata car.

The company is also experimenting with cost-saving manufacturing techniques. Instead of welded bodies, for instance, Tata may choose bolted or glued panels. The challenge will be to meet stringent safety norms at the same time. The company is also planning to outsource about 80% of component manufacturing to inexpensive Indian suppliers.

FRESH EYES

THE NEW TATA CAR is innovation on an industrial scale. But mass-market techniques, Indian-style, can be applied to health care, too. Witness the Aravind Eye Care Centre in the southern Indian city of Madurai. Designed by an ophthalmologist named G. Venkataswamy, the Centre has developed inexpensive cataract surgeries for \$50 to \$300, compared with just over \$2,000 in the U.S. The procedure's price even includes the cost of a locally made intraocular lens, inserted during surgery to restore sight.

Well-to-do Indians are charged the higher fee, which partially subsidizes operations for the poor. But the key to keeping costs down is the huge volume of surgeries and the efficient system the doctors have developed. At Aravind's three hospitals, 80 doctors perform 50 surgeries a day. At any one time in the operating room, four doctors are working on patients side-by-side. Patients are returned to their village the next day, where paramedics complete the postoperative care. In technical jargon, this is "process innovation." India seems to excel at it. "Process innovation is a critical step in making products and services affordable for the poor," says the University of Michigan's Prahalad.

Moreover, doctors say, the assembly-line procedure doesn't hurt the results. "The quality is stellar," says Burjor P. Bhatnagari, a well-known ophthalmologist in Bombay. Aravind says it manufactures the intraocular lenses used in the operation for \$5 each—a big savings from the

The Indian Way: Inventive Yet Practical

Local entrepreneurs and companies are creating low-cost, high-quality products and services

TATA CAR

The Tata Motors \$2,200 compact will be the world's cheapest car. A prototype of this motorbike-auto hybrid will be ready in 2005.

ARAVIND EYE-CARE SYSTEM

Thanks to assembly-line surgery, plus locally manufactured intraocular lenses, cataract operations go for as little as \$50 each.

JAIPUR FOOT

The sturdy \$30 prosthetic foot is made from the outer material of satellite rocket launchers made by the Indian Space Research Organization and is exported to developing markets.

ELECTRONIC VOTING MACHINE

This dust and tamper-proof \$200 voting machine with an embedded microprocessor can be used by illiterates. The machine delivers election results in 24 hours—a time saving of 70%.

COMPUTER-AIDED LITERACY PROGRAM

Tata Consultancy Services devised a computer-aided program to teach India's 200 million illiterate adults to read using obsolete computers. Development cost: Just \$100,000.

SECURITIZING MICROFINANCE LOANS

ICICI Bank is reducing the cost of its rural microfinance program and bringing more money into rural India by securitizing microfinance loans—much like mortgage-backed securities.



INDICA

A big success at \$6,600

THE UNCONFLICTED INSTITUTIONAL BROKER

[illegible]

Faqir Chand Kohli



Former chairman of Tata Consultancy Services, India's software outsourcing pioneer, and a champion of cracking the country's adult literacy problem.

“About the digital divide in India: How deep is it?
I don't think there's really a divide. The question is, are you using technology for everybody? China has six times the number of computers that India has and has written lots more software in Mandarin and Cantonese for its own people, whereas we have done it for others. China has used computers effectively in manufacturing, in agriculture. This year, China will install 13 million PCs, 8 or 9 million of which they will make themselves. We have just 3 million PCs. It's not that we are not doing well, but we are not doing enough.

We have to have a domestic digital industry and speed up computer use. It's doable to make a sub-\$200 PC, but it needs a huge initiative. We need more microelectronic engineers who understand the hardware. We have requested the government to select 40 more colleges to provide a master's program in microelectronics.

Hopefully, in the next 12 to 18 months we will break the back of the PC problem and have software in all Indian languages. Then the fun starts, when everyone will use it.

Can India be a source of deep, real innovation?

For us in India, the cost of doing innovative technology is very, very low. The capability of India is its people. I admire China, but our people are better. India has ingenuity. We have more than our fair share of intelligent, hard-working people, great raw material and assets. We have to learn how to use them.



\$50 the hospital once paid the American company Allergan for lenses approved by the U.S. Food & Drug Administration.

If Aravind's cataract surgery is a triumph of process, the prosthetic Jaipur Foot is a triumph of product. The \$30 artificial limb was developed in the late 1960s by Ram Chandra, a temple sculptor from the north Indian city of Jaipur. He observed that patients in his city had trouble using imported artificial limbs, which can't accommodate Indian postures like squatting. So he set out to improve things.

SECURE VOTING

THE JAIPUR FOOT is made from a rubberized material and more flexible than many standard prosthetic feet available in the U.S., which cost from about \$250 to \$1,500, depending on their range of motion. And the Jaipur Foot is suitable for long periods of immersion in water—essential for farmers who stand barefoot for hours in rice paddies. Its movement at the knee and ankle allows Indians to comfortably squat, sit cross-legged, and walk barefoot, as is often their custom. The prosthetic limb costs so little because it's made from cheap yet sturdy materials, and its labor-intensive assembly does not require the use of high-cost machinery.

Distributed by a charitable organization known by the acronym BMVSS, the Jaipur Foot is exported across the developing world, from Afghanistan to Rwanda. Two years ago, the BMVSS created a partnership with India's satellite space-research program, the Indian Space Research Organization to improve the limb and further reduce its cost. The Jaipur Foot will soon be manufactured using polyurethane, a lightweight material normally used for making rocket propellant. The new outer material will reduce the weight of the foot by half and cut production costs by about 10%, to \$27.

There are many more low-cost Indian innovations—from Bharat Electronics Ltd.'s tamper-free electronic voting machine to Tata Consultancy Services' computer-aided literacy program. Bharat Electronics sees huge export potential in its \$200 suitcase-size voting machine, which illiterates can use to cast their electoral ballots. Unlike the electronic voting machines used in the U.S., which are networked through personal computers, the Indian machines run on software embedded in a microprocessor that cannot be reprogrammed. That means they can't be hacked.

Computers are also helping literacy

grow in India. For just \$100,000, TCS software engineers developed a program to teach India's 200 million illiterates to read. Words float across screen while a narrator repeats the sound that most closely represents the word, such as “m” for “mother.” In one test, TCS engineers found that in 10 weeks, adults learned enough to sign their names and slowly read a newspaper.

India's largest private bank, called ICICI, has also created innovation through small loans given to self-employed farmers and craftspeople. Following the example of mortgage-backed securities, ICICI last November decided



JAIPUR FOOT The limb works even for a rickshaw driver

to bundle \$5 million of loans from India's top

best microfinance institutions, and sell them as securities yielding double-digit returns. By connecting capital markets to India's small entrepreneurs, the bank demonstrated that securitization could eventually create a new instrument for microborrowers across the world.

Banking. Education. Health care. Autos. In these areas and beyond, India are increasingly demanding better products and services at an affordable cost. Strong economic growth this year will only enlarge that demand. The phrase “Made in India” may come to represent low-cost innovation in the new global economy. ■

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Huawei: More than A Local Hero

The telecom gear maker aims to be a player in global innovation. By Bruce Einhorn

XU DANHUA, a 37-year-old engineer at China's premier tech company, stays plenty busy. As chief of the "pre-research" department of Huawei Technologies Co., Xu has his hands full developing products for the "digital home"—all the gizmos and technologies that will soon link PCs, TVs, stereos, and other devices to the Internet and each other in living rooms, kitchens, and bedrooms. "I like to face the challenges of new technology," says Xu, a six-year veteran of the company. "Huawei is a company that very quickly takes on the trends of the industry."

SHOP FLOOR At a Huawei factory in boomtown Shenzhen

tems Inc. alleging patent and copyright infringement. Now, Huawei aims to move far beyond its Chinese roots by selling sophisticated gear to customers worldwide and tapping talent in Europe, India, and the U.S. "Huawei is a global company with global markets in mind," says Li Xiaotao, the company's 36-year-old head of research and development.

Li and his colleagues are attempting to create something the world hasn't seen before: a developing-world multinational that is broadly based, research-intensive, and able to stand up to the best in the business. And Huawei's leaders want it all. Rather than sticking to one segment of the vast world of telecoms, the company's engineers are designing their own semiconductors, developing next-generation networking equipment for telecom operators, and creating new third-generation (3G) mobile phones for consumers.

Huawei's global innovation drive dovetails nicely with the government's goals. Beijing is keen to make China a leader in technology to reduce manufacturers' reliance on foreigners for key components, and to narrow the gap with Taiwan, Japan, Europe, and the U.S. China's leaders figure the local heroes can take advantage of the country's large home market and talented engineers to help set the standards for emerging technologies such as 3G, the digital home, and the next-generation Internet. "[The Chinese] want to become more influential," says Charles Yen, managing partner at Deloitte Touche Tohmatsu in Beijing.

A-LIST PARTNERS

SO FAR, HUAWEI has made the biggest global splash. It's a market leader in DSL equipment, used for high-speed Net connections, as well as next-generation networks, which let telecom operators send voice, data, and multimedia messages over the Internet. Huawei has A-list partners, including Intel, Microsoft, and Qualcomm. Overseas sales doubled last year, to \$1 billion, while total revenues increased 41%, to \$3.8 billion. That's peanuts for Sony or Microsoft, but it puts Huawei in the top league of Chinese tech companies. And Huawei this year is likely to spend \$500 million on R&D. Again, that's small by international standards, but it's more than 10% of revenues—a hefty commitment for a Chinese company and enough to pay for more than 10,000 engineers. Huawei "is becoming a powerhouse because it is investing in its own technologies," says Albert Lin, an analyst at American Technology Research Inc. in San Francisco.

All those engineers are staying busy. A big chunk of R&D money is being used to develop equipment for an upgraded version of the Net called Internet protocol version 6 (IPv6). Beijing is heavily pushing IPv6, an initiative that could help China catch up with the U.S., which has dominated Net development so far. Another project is a partnership with Siemens to devise phones and gear for a Chinese-developed 3G standard called TD-SCDMA, which Beijing hopes will sell big in China and abroad. And Huawei is a world leader in next-generation networks, along with Alcatel, Nortel, and ZTE.

Now, Huawei is making its innovation effort a global push. China has long envied India's software services, so Huawei has sought to tap the engineering talent that has made India so successful. A few years ago, the company started recruiting

Huawei Thinks Big

How China's IT leader is turning itself into a global powerhouse

R&D WORKERS 10,000 (46% of total workforce)

LABS In Britain, India, Sweden, the U.S., and seven cities in China

PATENT APPLICATIONS 1,590 last year, up 33% from 2002

CUSTOMERS 87 telecom operators in 31 countries

PARTNERS Microsoft, 3Com, Siemens, and Qualcomm

NEW PROJECTS 3G phones, next-gen telecom networks, and Internet gear

Data: Company reports

engineers from India, and today 100 of them work at its headquarters in Shenzhen, the boomtown adjacent to Hong Kong. At the same time, Huawei understands it's more efficient to hire Indians in India than to bring them to China. So in 1999, it opened a development center in Bangalore, where 700 researchers now work. By the end of next year, it hopes to expand the Bangalore operation to 2,500 engineers. The company also has smaller labs in the U.S. and Europe.

The next step is to raise Huawei's international profile. The company is encouraging its engineers to contribute more to organizations such as the Inter-

That's just the kind of endorsement Huawei execs—and China's leaders—like to hear as they seek to leap into the big leagues of global innovation. Like other Chinese electronics outfits, privately held Huawei made its name as a low-cost manufacturer of equipment first developed elsewhere. With the bulk of their sales in China, Huawei, PC maker Lenovo, appliance producer Haier, TV manufacturer TCL, and others have prospered by selling products with relatively simple technology while capitalizing on close ties with local officials to give them a home-field advantage over foreign rivals.

But with competition at home picking up now that China is a member of the World Trade Organization, many Chinese companies are looking to be more than just local heroes. Huawei, for one, is eager to shed its "me-too" image and recently settled a 2003 lawsuit filed by Cisco Sys-

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Yuan Longping



Director general of China's National Hybrid Rice Research & Development Center and a pioneer in hybrid rice technology

“What remains to be done in addressing global food shortages?

Food security is still a very serious problem because of the growth of the world's population and the reduction of arable land. Some experts estimate that in the year 2030, the world population will be 8 billion. Now it is about 7 billion.

What's the answer?

The only way to solve the food shortage problem is to increase the yield of the grain crop per land area through the advancement of science and technology.

What innovations must you use?

The big change, I think, is the use of biotechnology. We must incorporate this approach into our breeding program. In the materials we need to use in [hybrid] rice, their potential is almost tapped. So we must find a new source, other than rice, with new genes. But if you want to use new genes from another species, you cannot use conventional methods. We must use biotechnology.

Many in the West distrust genetic engineering. Does this concern you?

There are many kinds of genetically modified crops. In some transgenic plants [which contain artificially introduced genes], the genes from microorganisms such as bacteria help the plants to resist insects. Bugs that eat these plants will die. How about the effects on human beings? For some genes, we should be very careful. But for genes from maize or wild rice, there should be no problem.

national Telecommunications Union that establish standards for new technology. This year, Huawei will submit some 200 proposals on standards to such groups, up from just 17 in 2001. And it's pushing engineers to apply for more patents. Last year, the company's worldwide patent applications grew by a third, to 1,590. Overall, Huawei has received hundreds of patents, but just a handful come from the all-important U.S. To crank up the pace of innovation, the company designates employees who come up with patentable ideas as "Huawei Innovators"—and gives them a medal and cash awards of as much as \$1,200.

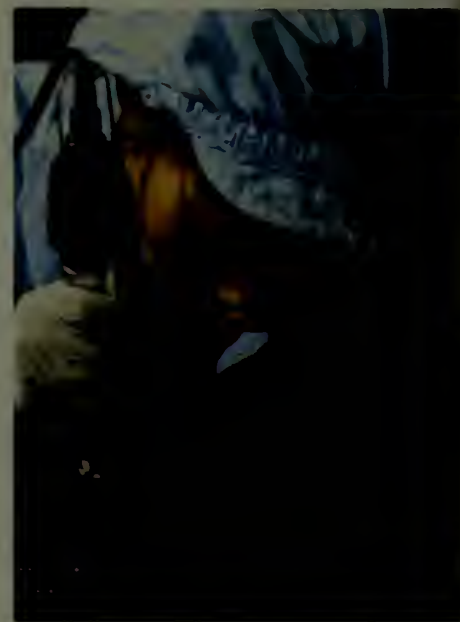
FOLLOWERS?

THAT MIGHT NOT SEEM like much to an engineer in San Jose or Stockholm, but in Shenzhen it goes a long way. Thanks to China's low costs, R&D chief Li boasts that Huawei gets more bang for its R&D buck than foreign rivals do. The starting salary for a Huawei engineer is about \$6,600 a year, and its top performers earn up to about \$22,000, compared with the \$180,000 they might earn in the West. "In North America and Europe, where they have one engineer, in China we can hire 5 or 8 or 10," he says. Many of Huawei's researchers live in a complex of 3,000 apartments adjacent to the company's 320-acre campus—which makes it easy for them to stay focused. And Huawei's engineers are a talented bunch, says Lawrence B. Prior III, who until September served as CEO of LightPointe Communications Inc., a San Diego manufacturer of optical wireless equipment, in which both Huawei and Cisco own a stake. Huawei is "full of technical over-achievers," Prior says.

One of those overachievers is Teresa He. She's the head of R&D for ASICs, semiconductors that are tailored for specific tasks in devices such as Huawei routers and switches. In the mid-1990s, Huawei could barely afford the basics to do the work. Without enough equipment to go around, He had to make time-sharing deals with colleagues to use key testing gear that went for the extravagant sum of \$60,000. "You could use the machines for only two or three hours, and then you had to give way to the next person," she recalls. No longer. When He needed a \$3 million machine for testing Ethernet switches recently, she had no problem getting the cash.

Not everyone is convinced that Huawei or other Chinese companies have what it takes to make the leap to the top ranks of global innovators. "They are a

very strong, capable company," says Hong Lu, CEO of UTStarcom in Alameda, Calif., one of Huawei's biggest competitors in China. But, Lu says, "they are followers, not innovators. In the past, they have always done things that others have already done." And while Huawei and its compatriots have made progress in R&D, some say the real innovation will come from foreign companies opening their own research facilities on the mainland. On Sept. 10, Motorola said it would spend about \$90 million on an R&D center in Beijing. A few days earlier, Lucent Technologies announced plans to invest \$75 million in an R&D center for its 3G cellular



TECHNICIAN
Working on a
Huawei board

lar unit in the eastern city of Nanjing. "The Chinese haven't created a culture of innovation," says Dave McCurdy, president of the Electronics Industry Alliance, a lobbying group for the U.S. electronics industry. "Foreign-owned enterprises in China will be the centers of innovation."

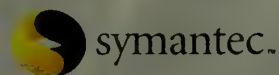
R&D chief Li counters that the foreign investment actually helps Huawei. The competition, he says, raises the overall level of available talent. "The usual practice in the past was to recruit people from universities and then train them to be good engineers," says Li. Now Huawei can raid other companies for talent, he says. That trend cuts two ways, though. With more competition, salaries are going up. Nonetheless, Huawei is betting that those newcomers, combined with its current stable of engineers, will propel it into the ranks of the global innovation elite. ■

—with Manjeet Kripalani in Bangalore and Jack Ewing in Frankfurt



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The Old World Becomes a Little Newer

The trend toward collaborative innovation will help the Continent revive its R&D. By Andy Reinhardt

EUROPE HAS LONG BEEN AN innovation leader. Centuries ago, Johannes Gutenberg revolutionized practically everything with his technological marvel, the printing press. Europe's modern-day innovators have changed how we work and play with inventions such as compact disks, the World Wide Web, and the Linux operating system. Today, engineers at Airbus are pushing the envelope with the world's biggest commercial aircraft, the 600-seat, double-decker A380 superjumbo. And Europe still dominates mobile-phone technology, thanks to local champs Nokia, Ericsson, Siemens, and Alcatel, which together spent \$13 billion on telecom research and development last year. "There's an enormous amount of technical talent in Europe," says Joël Monnier, director for central R&D at European chip giant ST Microelectronics in Geneva.

Yet despite the successes of solo inventors and big companies, Europe's place as a technological leader is far from assured. Overall R&D spending lags behind that of the U.S. and Japan. R&D spending in the 15 (pre-enlargement) European Union member countries clocked in at just under 2% of gross domestic product in 2002—the most recent year tallied—compared with 2.7% in the U.S. and just below 3% in Japan.

Worse, venture-capital investment in European tech startups—a key ingredient for innovation—was less than a quarter of that in the U.S. last year. For European scientists and engineers, it's tougher to cash in on their inventions by starting up new compa-

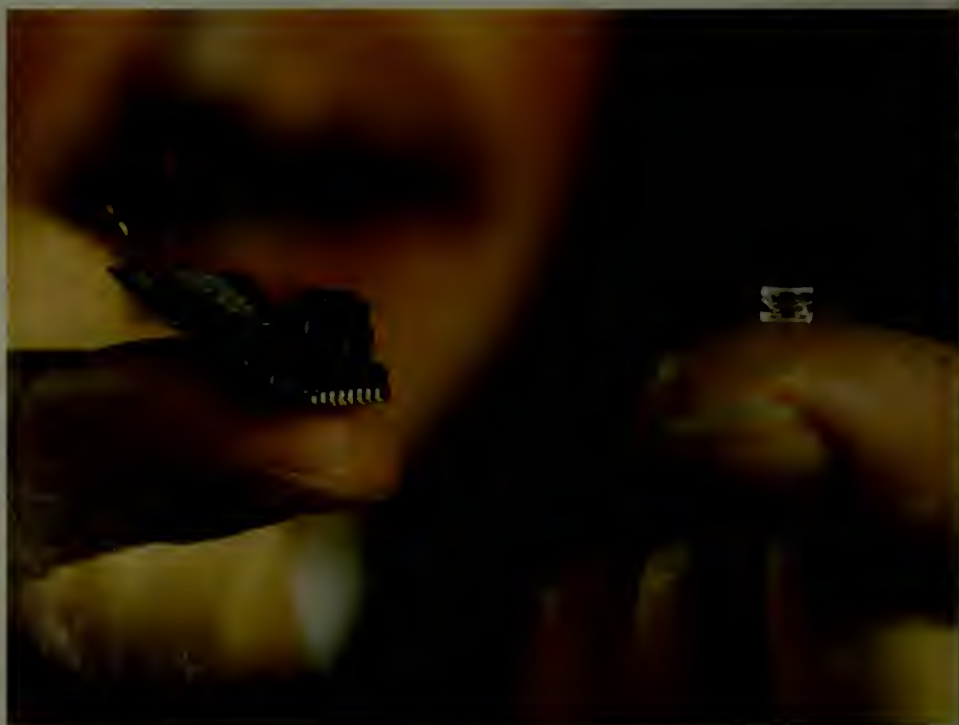
VISION THING
Working on
lenses at
Philips

nies. The lack of incentives has spurred an exodus of smart people from the Continent. An estimated 400,000 European scientists and engineers now live in the U.S., and a 2003 study found that among Europeans who got PhDs in the U.S. in the 1990s, three-quarters have no plans to return home.

What's the Old World to do? From the corridors of Brussels to corporate laboratories, Europe is working to overcome these obstacles. EU policymakers had already declared, in 2000, that they wanted the Continent to boast the world's most dynamic knowledge-based economy by 2010. Now they are pushing to boost R&D spending by governments, universities and corporations to a total of 3% of GDP within the decade. That will require raising overall spending by 6.5% annually—two more points than the current rate—and hiring 700,000 researchers.

European R&D spending has already climbed a bit—about a half of a percentage point—since 2000, but Europe may have a hard time hitting its 3% target unless companies step on the gas, says Georges Haour, professor of technology management at IMD business school in Lausanne, Switzerland. He's not writing off Europe, though. "What really counts is the effectiveness of the innovation," Haour says. "If you spend less but get more bang for your buck, it's even better."

That's why policymakers are also trying to improve the climate for innovation in Europe. The EU is working to attract more women into science and knock down barriers that hamper technology transfe-



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[illegible]

Tim Berners-Lee



The London-born inventor of the World Wide Web is now at Massachusetts Institute of Technology working to create the new "Semantic Web," a radical leap that would greatly improve how people and machines locate and use data on the Web.

“The Semantic Web is meant to add levels of meaning to online information. Tell us about that.”

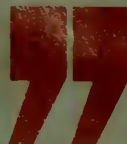
The Semantic Web is a space for data. Currently, there is a huge amount of data in databases, in spreadsheets, and in application files like calendars, photos, and so on. Some of this data is available to people viewing the Web through a browser, but it can't be used by other applications, and it can't be accessed as data.

The Semantic Web is about breaking down the barriers between data in different applications and different enterprises. It works by describing the real things—people, products, events, and so on—and then explaining to the computer how the data relate to those things. This provides the links between systems. It is a very decentralized system—a tangle of weblike links, not a top-down design.

When you're looking at a major innovation challenge, like finding new drugs, or finding a cure for AIDS or cancer—these involve so much data from so many different fields that we're going to need the Semantic Web before we can crack the problems.

How close are we to the realization of that vision?

It is happening now in certain areas. But I sense it will be 5 to 10 years before we get to the state, like with the Web now, where you can assume most information is available in a data form and you're worried if it's not.



among universities, public research labs, and private companies. National and regional governments are promoting technology clusters such as the emerging "Telematics Valley" in Göteborg, where car manufacturers and wireless companies collaborate on mobile-communication systems for motor vehicles.

Some efforts are bearing fruit. Following the model of Silicon Valley's ties with Stanford University and University of California at Berkeley, dozens of technology parks are springing up around European schools. Prominent examples include the Roslin BioCentre near Edinburgh, where Dolly the sheep was cloned, and the IMEC semiconductor cluster in Leuven, Belgium. In Germany, the renowned Max-Planck research institute has established a tech transfer unit that has helped seed 64 startup companies in partnership with venture capitalists.

In the corporate world, the trend toward creating innovation networks also plays to Europe's strengths. Since World War II, Europeans have had plenty of practice in collaborative ventures, from the Ariane rocket to the GSM mobile-phone standard. Royal Philips Electronics is a leading proponent of this style of cooperative innovation. In June, the Dutch giant opened a new 28,500-square-foot semiconductor clean room in Eindhoven, Netherlands, that is also available to other companies who lease space to develop—and sometimes share—technology there. "The era of doing everything yourself is over," says Rick Harwig, chief executive of Philips Research in Eindhoven. One Dutch startup, called fluXXion, is already using the lab to produce filtration systems so precise that they can screen bacteria out of milk. Meanwhile, Philips continues to roll out innovations of its own there, such as a new biosensor chip for fast, accurate blood tests, and a technique for etching flat-panel display circuitry using a modified inkjet printer.

With smaller domestic markets in which to grow, Europeans grew accustomed to doing business across borders long ago. "We have to think in multinational terms," says Marten Mickos, CEO of Swedish software company MySQL. That makes Europeans more experienced in dealing with a patchwork of languages, business rules, and cultures—a skill increasingly necessary for global success. Take Germany's SAP, the world's No. 1 seller of run-the-business software. It started setting up research labs outside its home country a decade ago. The goal: to tap into local knowledge, get closer to customers, and save money by hiring cheap-

» Philips is leasing space at its new research facility in Eindhoven to other companies, with frequent tech-sharing the result

er talent. Now, some 30% of SAP's 10,000 engineers are based outside Germany, locales ranging from the U.S. to India to Romania. But SAP still keeps 70% of its R&D at home in high-cost Germany to take advantage of the country's "culture of great, hard-working, intelligent engineers," says Leslie Hayman, global head of human resources.

To be sure, Europe still has its work cut out catching up with the U.S. in supporting research. But R&D spending alone isn't an adequate metric for innovation. In an increasingly interconnected world, Europe's ability to collaborate across borders "could turn out to be a more sustainable model for innovation," says David E. Schindel, former head of the U.S. National Science Foundation's European office. If the Old World unites around its impressive strengths, it may help drive the next innovation era. ■

—With Jasper Perkins in Paris

European Innovation

» Although it spends less on R&D than the U.S., Europe still has strong points:

◆ Europe is strong in aerospace, automotive, mobile communications, physics, microbiology, high-speed trains, alternative energy, and semiconductors

◆ World-class labs like CERN and Max-Planck complement big corporate R&D from DaimlerChrysler, Siemens, GlaxoSmithKline, Nokia, Philips, and dozens more

◆ A postwar history of setting cross-border standards and of collaboration positions Europe to succeed in a new innovation era that requires cooperation and a global mind-set

Data: Bureau of Economic Analysis

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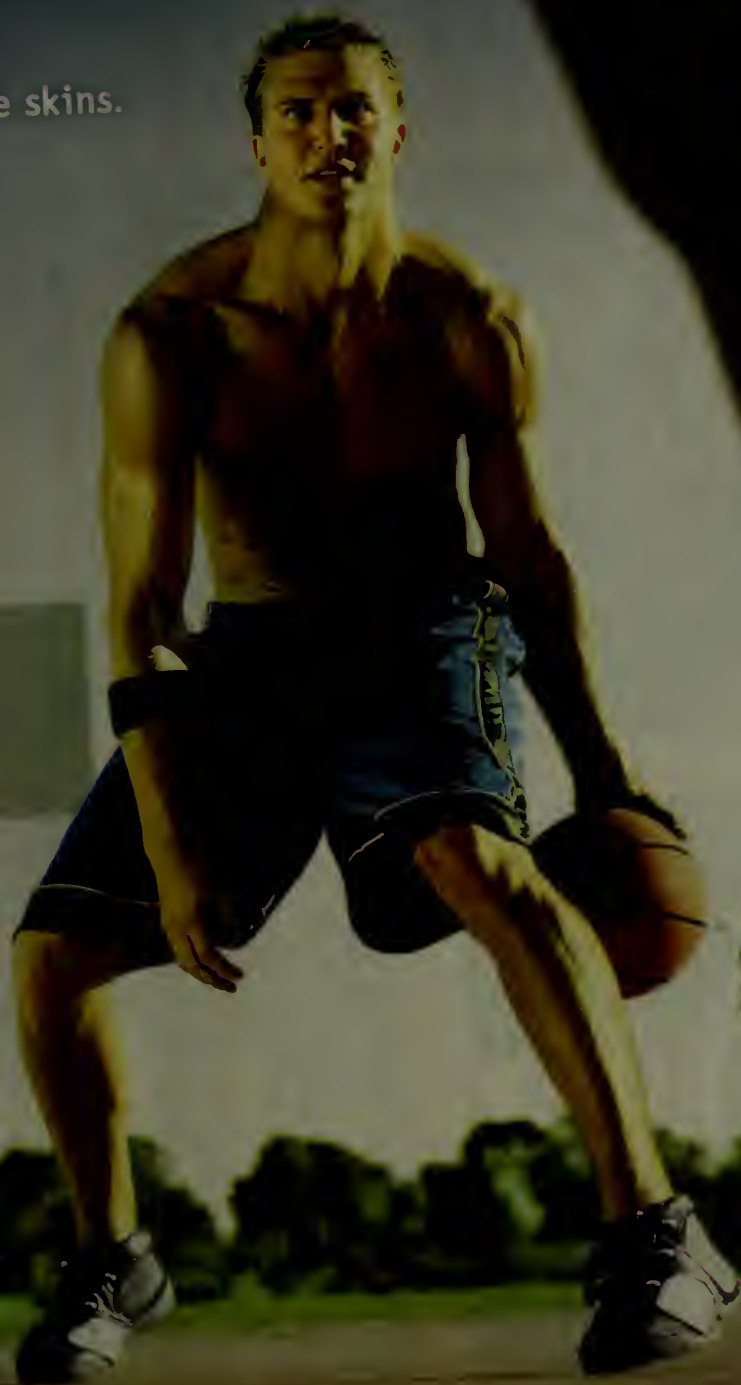
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THE INNOVATION ECONOMY

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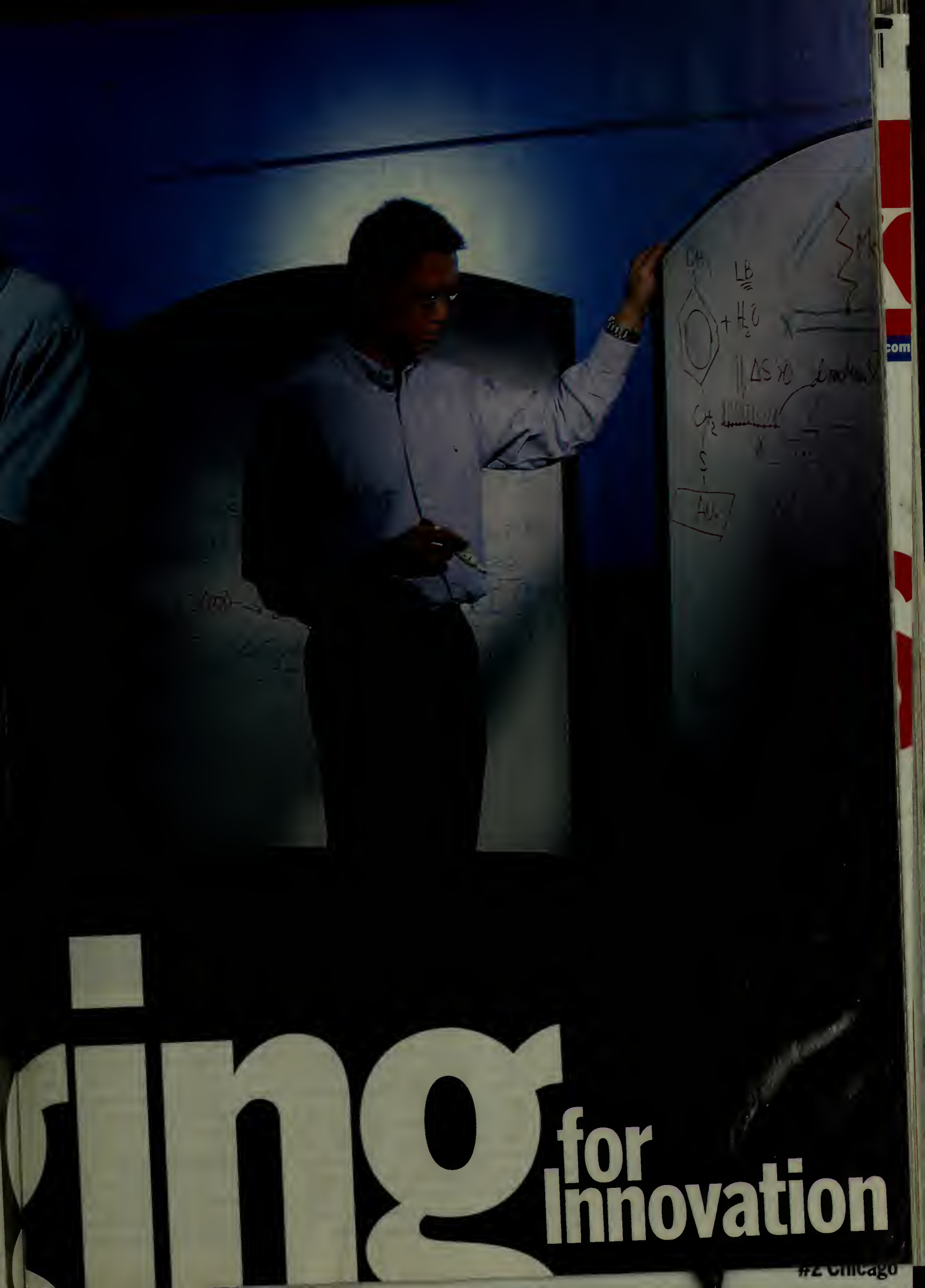
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At Hewlett-Packard, making sure engineers from different disciplines are on the same page

STEVE LABADESSA

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ing for Innovation

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Building An Idea Factory

Inspiration is fine, but above all, innovation is really a management process. By Robert D. Hof

ASK MOST PEOPLE WHO invented the lightbulb, and they will promptly provide the wrong answer: Thomas Alva Edison. Truth is, the famous inventor's 1879 debut of his incandescent light trailed others by decades. So why does he get all the glory? Mostly because of what he did next, notes Andrew Hargadon, author of *How Breakthroughs Happen: The Surprising Truth about How Companies Innovate*. To get his creation to the masses, Edison and his team of engineers in Menlo Park, N.J., spent years building the entire electric system, from light sockets and safety fuses to generating facilities and the wiring network. Only then did the electric light flare into the innovation that lit the world.

In short, Edison beat all his predecessors at one crucial task: managing the whole process of innovation, from lightbulb moment to final product. Today that task is scarcely easier than it was 125 years ago. Sure, it's easy to get lucky once in a while. The real trick is doing it over and over again. "Managing innovation means cultivating an environment where lightning can strike twice," says Paul Saflo, research director at the think tank Institute for the Future. "It's extraordinarily difficult."

To hard-headed business people, innovation often seems as predictable as a rainbow and as manageable as a butterfly. Penicillin, Teflon, Post-it Notes—they

sprang from such accidents as moldy Petri dishes, a failed coolant, and a mediocre glue. It's no wonder so many executives throw up their hands. "Our approach has always been very simple, which is to try not to manage innovation," shrugs Silicon Valley venture capitalist Michael Moritz, a partner with Sequoia Capital. "We prefer to just let the market manage it."

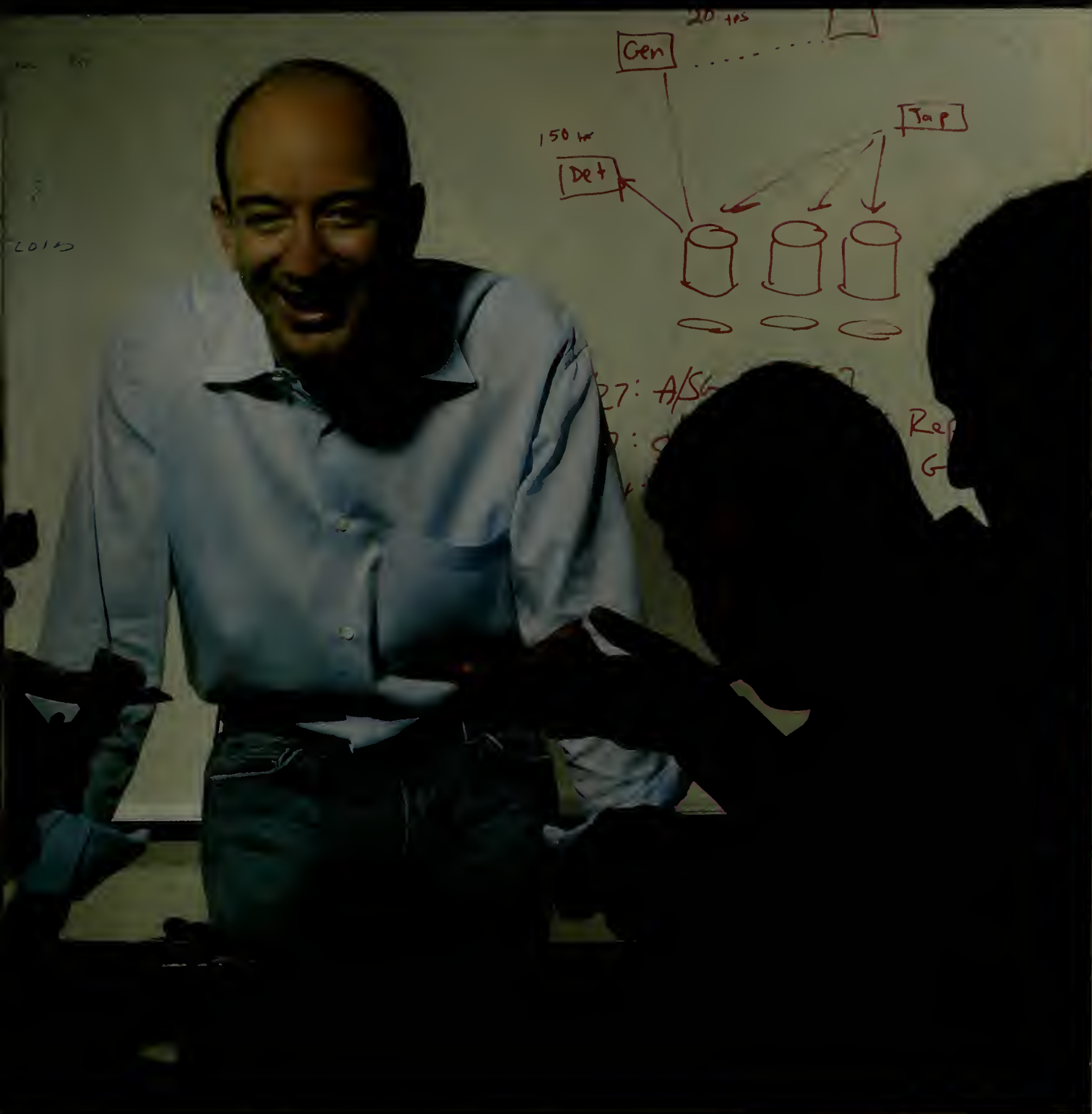
Yet even in the Darwinian chaos of Silicon Valley, innovations are made, not born. The world's most innovative companies, from Procter & Gamble and Toyota Motor to Apple Computer and Edison's own General Electric, make their own luck. They plunge ahead on

new ideas even though they know most will fail. "You have to go down blind alleys," says Jeffrey P. Bezos, founder and chief executive of pioneer online retailer Amazon.com Inc. "But every once in a while you go down an alley and it opens up into this huge, broad avenue. That makes all the blind alleys worthwhile."

"COMMODITY HELL"

PROBLEM IS, A LOT of forces today conspire against innovative products getting to market. Small outfits that are often the most innovative get short shrift because





ayers aren't sure they can deliver or even arrive to keep supporting their products. And for large corporations, there's the innovator's dilemma" coined by Harvard Business School professor Clayton Christensen. By catering to their best customers with increasingly advanced and more expensive products—a seemingly sensible approach—successful companies ignore or even discourage less profitable low-end products. But as startups produce these low-end products and they improve, they eat into the core markets of large companies. Thanks to such innova-

tions as Internet phones, discount airlines, and open-source software, the innovators' dilemma is now afflicting blue-chips AT&T, United Airlines, and Microsoft. Says Gerard M. Mooney, vice-president and director of corporate strategy at IBM: "All big companies have trouble coming up with the Next Big Thing."

Managing innovation better may be the only way out of the "abyss called commodity hell," as GE Chief Executive Jeffrey R. Immelt has put it. Today, having the biggest factories or running the most ads is no longer enough to stay ahead. Shorter

Amazon

TRY, TWEAK, AND TRY AGAIN: The e-tailer struck out when it tried auctions à la eBay. But thanks to CEO Bezos' "culture of divine discontent," Amazonians kept pushing, coming up with the idea of letting other merchants sell on its pages. Profit margins on those sales have helped Amazon log four straight profitable quarters.



Starbucks

INVENTING MARKETS, NOT JUST PRODUCTS: Never just a coffee joint, Starbucks views itself as a "third place" to hang out. That's why wireless Net access paid off. Subscribers visit more and stay longer. And the network is the foundation for a new music-CD-burning service.

product cycles, ultra-efficient contract manufacturers that upstarts can use to enter a market fast, and a glut of factory capacity that depresses prices—all of those render traditional Industrial Age competitive advantages moot. Serial innovation may prove to be the key skill of the Information Age. "Serendipity is nice, but we can't leave this to happenstance," says John Seely Brown, a visiting scholar at the University of Southern California's Annenberg Center for Communication and former chief scientist and head of Xerox Corp.'s legendary Palo Alto Research Center. "We just don't have the money any longer to screw around."

The good news is that crisis is the mother of innovation. The economic boom of the 1990s produced a raft of nimble new rivals, forcing established companies from IBM to Procter & Gamble to shake up longstanding habits. And even if some of those threats looked less fearsome as the economy soured, the savviest CEOs realized it was a competi-

tive advantage to continue pushing their troops to rethink how they develop products and services—in a sense, to rethink innovation itself. "We went through a really tough patch in 2000," says P&G Chief Technology Officer G. Gilbert Cloyd. "That got us moving."

Some of the methods companies are using to spur innovation, such as setting impossibly high goals and relentlessly experimenting, will sound familiar in places like Silicon Valley. But they're often considered unwise or frilly by traditional corporations. Others, such as opening up company procedures and research to the outside world, are new and controversial. One thing underlies them all: courage. The companies that have endured are those whose leaders bet the future not just on marketing savvy or manufacturing might but on innovation.

RISKY GOALS

FOR ONE, THEY'RE NOT afraid to think big and tackle goals that others deem too risky. Consider Apple Computer Inc. In early 2001, the Cupertino (Calif.) personal-computer pioneer hit on the idea of making a digital music player as easy to use as Sony Corp.'s Walkman was for cassette tapes. Yet while the iPod debuted just nine months later, CEO Steven P. Jobs realized that selling hardware wasn't good enough. That's when he set to work on the seemingly impossible: providing easy, legal access to lots of songs, something no one had yet managed.

By April, 2003, Jobs had done it. But painstakingly working out digital-right issues with recalcitrant record companies. Apple opened an online download store that featured 200,000 songs, soon to grow to an unprecedented 1 million. Now Apple owns tech's hottest product, with total sales of 3.7 million iPods grossing \$1 billion. Says Jobs: "We can invent a complete solution that works."

What's more, Jobs's big bet has helped him redefine the company. Apple, with negligible 2% share of the PC market, has a shot at becoming a dominant force in the exploding market for digital entertainment. That kind of radical shift stands in stark contrast to the safe path too many companies take, says A. Richard Newton, dean of the College of Engineering at the University of California at Berkeley. "What's missing today is inspired leadership that has a lofty enough vision to spu-

» One adjustment to Toyota's manufacturing system slashed 75% off the cost of refitting the production line



7am-10am: Last minute client meeting in Beijing to discuss major structural change.

11am-4pm: Intense meeting with engineers to defy laws of physics.

7pm-11pm: Motivational meeting with contractors to pull off the impossible.

(11:10pm: Angry voice message from fiancée in Los Angeles complaining that you forgot to call.)

Life's

great things along the way," says Newton.

Thinking big is important, but sweating the details is just as critical to spurring continuous innovation. Several years ago, Toyota Motor Corp. made one change to its production lines, using a single brace to hold auto frames together instead of the 50 it took previously. In the context of Toyota's famously complex production system, it looked almost insignificant. But this Global Body Line system helped slash 75% off the cost of refitting a production line. And it is the reason behind Toyota's ability to make different models on a single line. The change contributed to manufacturing cost savings of \$2.6 billion last year, helping produce profits in the year ended Mar. 31 that topped those of Ford Motor Co. and General Motors Corp. combined.

It's a testament to the importance of managing the thousand-and-one small innovations that together become something transformative. Through a process called *kaizen*, the Japanese word for continuous improvement, the auto maker relentlessly tries to find ways to enhance every step from design through assembly. "Every day, every minute, they're trying to improve their production systems or productivity or quality," says Goldman Sachs & Co. auto analyst Kunihiko Shiohara.

That requires perhaps the most fundamental quality of innovative companies. They never stop hammering away at problems and opportunities. They know that if they do, someone else will hammer them. Says John L. Hennessy, president of Stanford University and co-founder of chip designer MIPS Computer Systems: "It's better to shoot yourself in the foot than to allow somebody else to shoot you in some more vital part of the anatomy."

When Amazon.com managers noticed in 1999 that eBay Inc. was taking off, for instance, they launched their own auction site to tap into the same group of sellers—and the high-margin stream of commissions. But eBay's momentum was too great, and Amazon's auctions largely fizzled. Amazon also opened zShops, a gallery of independent merchants on its site, but that attempt to create a marketplace didn't catch fire either. In late 2000 an Amazonian came up with yet another idea: Let other sellers offer their wares on the same page as Amazon's own products. "Inviting third-party sellers onto our prime real estate—that made some palms sweat," Bezos admits.

But the Seattle-based company plowed ahead, and this feature has turned into a hit. Now some 26% of unit sales on Amazon.com are by other sellers, who like

how easy it is to list items. "The Amazon-selling platform is second to none," says Scot Wingo, CEO of ChannelAdvisor Corp. in Research Triangle Park, N.C., which helps large merchants sell on eBay and Amazon. The 60%-plus profit margin on the commissions and fees it charges other merchants has overcome any cannibalization. Bezos says people who buy used books buy more new books, too. All that has helped the company to log four straight profitable quarters.

"CONNECT AND DEVELOP"

BEZOS ISN'T JUST STUBBORN. He makes his constant experimentation economical by keeping project teams small and nimble. That way, even when they fail, they haven't spent much time or

money. Says Bezos: "To the degree that you can get people in teams small enough that they can be fed on two pizzas, you'll get a lot more productivity."

Increasingly, companies are rethinking where innovations come from. The best ideas aren't always inside corporate research and development labs, notes Henry Chesbrough, visiting assistant professor at UC Berkeley's Haas School of Business and author of the book *Open Innovation: The New Imperative for Creating and Profiting from Technology*. So it's becoming crucial to knock down walls inside the company—between research and manufacturing or marketing—while at the same time reaching outside the company for ideas. But it's not easy to do. Says Chesbrough: "There are powerful forces resisting the opening up of companies' innovation processes."

Nowhere was that more apparent than at Procter & Gamble. Growth and profits at the Cincinnati packaged-goods company stalled several years ago, partly because some costly products developed in-house tanked. New CEO Alan G. Lafley shook things up, replacing half of the company's top 30 officers and urging product groups to "connect and develop" by pulling in expertise from unrelated brands to help on new product creation.

For example, when P&G decided to move into a new market, the home car-care business, researchers didn't start from scratch. They looked around P&G for related expertise—and struck gold. The company's PuR unit's water



P&G

TEARING DOWN CORPORATE WALLS:

When the company entered the car-care market, it tapped in-house experts to produce the Mr. Clean AutoDry handheld sprayer, which soaps down cars and rinses them. It's a hit, more than doubling Mr. Clean brand sales in a year.

filter experts knew how to deionize water to get rid of minerals, and its Cascade unit already had a compound in its dishwasher detergent that reduced water spots. They used both technologies in what became Mr. Clean AutoDry, a \$24.99 handheld spray system. It's so popular that it has helped more than double overall Mr. Clean brand sales in the past year. It also showed the company a new way to innovate. Says Karen Ronn, vice-president of P&G's home-car division: "Innovation nowadays is mo-

(11:15pm: Call to fiancée to show
her you never stopped thinking
about her for a second.)

Good

The LG 3G Phone enables you to
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Life's Good

Jeff Hawkins



Creator of the first PalmPilot PDA and Handspring smart phone and author of the book On Intelligence, about the human brain and intelligent machines.

“Let's talk about serial innovators. What's the secret to success?”

I don't know if there's a secret to success. I've had a great deal of success myself. I also have had my share of failure. To me, being a great innovator is like batting in baseball. If you're batting .300 or .350, you're doing pretty well. Most people, they never get a hit. I try to think very hard about what's ultimately going to happen. Ultimately, everything's going to be wireless. Ultimately, everything's going to be portable. I figured that out a long time ago.

The trick is once you see that long-term vision, you then ask yourself, how do I get there step by step? You can't just solve all the problems at once and bingo, you have an industry. No, you have to solve a whole bunch of those problems, and along the way you have to make money while you're doing it.

And so what steps do you do? Even though I thought all computers would be mobile computers at some point, we said we can't do the wireless piece. We could do a connected organizer, and bingo, we did that. You always have the future vision in place. That tells you what you have to do.

Can a company be a big innovator?

Companies don't innovate; people do. If you're going to innovate, you have to overcome problems. In a startup, you're going to have all these people telling you you're wrong. If you're at a big company, you're going to have all these people telling you you're wrong. It takes a lot of nerve and perseverance. You have to keep fighting the battles.

like improvisation in jazz than playing out a score that's already written.”

Lafley didn't stop there. He also decreed that half the company's new product ideas eventually come from outside, up from 20% last year. That push has produced several popular products such as Olay Regenerist, a new antiwrinkle cream based on a skin-repair compound from a French company. The approach seems to be paying off. P&G's overall unit growth before acquisitions has jumped from zero in 2001 to 8% last year. For the fourth quarter ended June 30, overall profits shot up 44%, to \$1.4 billion, on a 10% rise in sales, excluding acquisitions.

Other companies are reaching out in more radical ways, such as tapping their own customers' expertise to develop fresh products and services. EBay CEO Margaret C. Whitman wasn't exaggerating when she told thousands of attendees at the online marketplace's annual conference of buyers and sellers in June, “You are in the room with us whenever we make a decision.” EBay watches what they trade on the site and flies in buyers and sellers for feedback. Effectively, it lets its customers decide where to expand next. That approach has paid off: 11 categories, from cars to jewelry, now top \$1 billion in annual gross sales each, and eBay's stock is worth \$59 billion.

EBay's approach may be hard for many conventional companies to emulate. But the notion of bringing customers inside to help develop new products is catching on in mainstream corporations as well. In 2000, for instance, IBM signed a deal with GM to co-develop a supercomputer for GM's car design and crash testing. The machine saved GM \$1 billion in product-development costs in the past three years and cut by as much as 64% the time to get a car from the design stage to the dealer's lot.

IBM may have gained even more. The work put into IBM's microprocessor chip, operating system, and other software to make it a leader in supercomputing also helped supercharge its commercial-server business. “We got a huge competitive edge,” says Bernard V. Schwartz, IBM's global account executive for GM product development. In late August market watcher Gartner Research said IBM expanded its leading share of the \$11.5 billion server market to nearly 31%.

The ultimate in innovation, though, is not merely to come up with new products and services. It's to create entirely new markets where none existed before—and better yet, to provide something that changes the way we live and work. Innovation was never just about new gizmos

and gadgets. But in a service economy, innovations more than ever must transcend objects. Some of today's most successful companies, from Virgin Group Ltd. to eBay, create not only innovative products or services but also novel business models.

“THIRD PLACE”

MOST PEOPLE MIGHT think of Starbucks for instance, as a fancy coffee joint. Not Chairman Howard D. Schultz. He sees the 8,000-store chain as a “third place” for people to hang out besides home and work. That's why a seemingly unrelated service offering wireless Net access in its stores starting two years ago—turned out to be a winner. Although Starbucks Corp. won't quantify the revenue impact, people using the service stay nine times longer than the usual five minutes, almost certainly buying more lattes. And 90% of customers who log on are doing so after peak morning hours, filling stores during previously light periods. Says Anne Saunders, Starbucks' senior vice-president of marketing: “If we'd on our own thought of ourselves as a coffee company, we wouldn't have done this.”

The wireless network also inspired a new initiative that could again remake the Seattle-based company. Its new Home Music Coffeehouses, about to be rolled out in existing Starbucks stores in Seattle with plans for up to 1,000 sites by the end of 2005, feature dozens of listening stations where people can make custom CDs at about a buck a tune, from hundreds of thousands of songs. In addition to offering a new service to 30 million weekly customers, Schultz has said he thinks Starbucks could transform the music business. At the least, he's transforming Starbucks once again.

Who ever would have thought that Apple and Starbucks might compete? Therein lies a fundamental constant of innovation: Nothing stays constant. Competing with innovation's disruptive influence requires what Amazon's Bezos calls a “culture of divine discontent,” which everyone itches to improve things. “Most people, unleashed, are innovators,” he says. “We're this great species of tool-using animal who likes to make the world better.” The companies that can unleash that particular animal instinct are the ones that will thrive. ■

—With Peter Burrows, in San Mateo, Calif., Steve Hamm and Diane Brady in New York, and Ian Rowley in Tokyo

BusinessWeek online For a Q&A with Procter & Gamble Chief Technology Officer G. Gilroy Cloyd, go to www.businessweek.com/75

Reaping The Wind

GE's energy initiative is a case study in innovation without borders. By Diane Brady

EVEN BEFORE AEOLUS CONTROLLED the tempestuous winds in Greek mythology, humans have dreamed of harnessing such power for themselves. But as a source of energy, the wind business is in its youth, populated mostly with niche players trying to build markets in a world where policies, cost, and technology still favor traditional forms of energy. General Electric Co. is setting out to change that equation by applying its considerable financial and technological muscle to the field. It launched GE Wind Energy in May, 2002, when it bought Enron's wind businesses after the company's collapse.

What makes GE such a force for innovation in this nascent industry is its ability to harness a vast array of global talent to develop new products and new technology. The \$134 billion giant already has people developing sophisticated composites that allow for lighter, stronger blades in jet engines. It has experts in the rail business who know how to make gearing systems operate at peak efficiency, and others who have vastly improved the efficiency of power turbines. And it can bring that talent together at major research centers in Shanghai, Munich, Bangalore, and upstate New York that serve all GE businesses.

While many companies boast a global workforce, few are as skilled at mobilizing experts from diverse disciplines and locales in pursuit of a common goal. The difference stems from culture more than from technology. At GE, executives are encouraged to think beyond the boundaries of their particular business. They come together frequently for training or joint projects. Executives are apt to move among units several times in their careers, letting them build up a rich network of internal contacts. There's also a tradition of plucking people from their day jobs for other projects. At any given time, thousands of GE employees are on



Brain Trust

» GE's wind turbines draw on global talent

 **U.S.** The main research center in Niskayuna, N.Y., handles basic research, while other centers in New York, Pennsylvania, South Carolina, California, and Virginia tackle other design and engineering.

 **CANADA** Engineers at GE Consumer & Industrial in Peterborough, Ontario, handled the manufacturing technology that goes into the generator.

 **INDIA** Bangalore researchers have crafted a series of analytical models and turbine system design tools that affect the entire turbine.

 **CHINA** Shanghai researchers are in charge of the turbine simulator to test new products and conduct high-end tests for variable-speed power electronics.

 **GERMANY** The lead experts on the gearbox work at GE Wind operations in Salzbergen. Researchers in Munich design sensors and monitor advanced controls.

Amory Lovins



CEO of the Rocky Mountain Institute, a nonprofit energy and environment policy think tank

“The U.S. economy is becoming more energy-efficient. How much further can this go?”

The U.S. now uses 43% less energy and 50% less oil per dollar of real gross domestic product than in 1975, mostly because of better technical efficiency. Yet this revolution has only just begun. We can profitably save over half our oil and gas, and nearer three-quarters of our electricity—that’s far cheaper than buying it. This efficiency revolution will be at the core of competitive advantage, and laggards will suffer.

How seriously is the need to cut back on fossil-fuel consumption being taken?

It has been taken very seriously by many state policymakers and in much of the private sector but by few at the federal level. Leaders in the transition beyond fossil carbon are earning startling returns. Such firms as DuPont, IBM, and STMicroelectronics are routinely cutting their energy intensity 6% a year, and seeing return on investment coming from retrofits to existing systems in just two or three years.

What will the energy future look like?

Wind, and perhaps coal [if CO₂ can be sequestered], will beat natural gas for making hydrogen, which will emerge as the dominant energy carrier. Ultralight hybrid vehicles will be ubiquitous. Most important, all energy uses will become far more efficient, so many of the new energy sources commonly proposed won’t be needed, and irrationally exuberant investors who support costlier forms of energy will lose their shirts.

so-called bubble assignments—lending their skills to another function or business that pays their salaries for the duration of the project.

Moreover, GE doesn’t treat its global outposts as farm teams for U.S. operations. Yes, there’s cheaper labor in places like Bangalore and Shanghai. But foreign researchers also handle high-level autonomous research projects that match anything being done at home. GE has set up state-of-the-art training centers to school foreign employees and customers in the GE way. The GE China Learning Center in Shanghai, for example, boasts many of the features of GE’s famed training facilities in Crotonville, N.Y.—including classrooms for up to 178 people.

That backdrop has been critical to building up GE’s market share in wind energy. It’s now a \$9 billion global industry that’s expected to grow 10% to 15% a year, says Steven Zwolinski, who heads up the wind business, now a part of GE Energy. The unit sold \$1.3 billion of energy-generating equipment last year to major utilities and developers. As technical innovations bring the cost of producing wind energy down and governments become more eager to develop renewable resources, growth could accelerate.

Certainly, that’s the expectation of James Lyons, a chief engineer at the GE Global Research Center in the leafy residential town of Niskayuna in upstate New York, who is charged with handling the advanced technologies for wind.

MULTILINGUAL MIND MELD

LYONS IS THE fulcrum for the project, charged with marshalling talent from around the world. The 30-year veteran has brought in engineers from other units and navigated cultural hurdles worldwide. Through his extensive internal network, he knew the people and skills he wanted. He has recruited materials experts from down the hall who developed the composites for the fan blades of the GE90 aircraft engine; design teams in Greenville, S.C., and Salzbergen, Germany; engineers from Peterborough, Ont., who are tackling the generators; Bangalore researchers who are crafting analytical models and turbine system design tools; and Shanghai engineers who conduct high-end simulations. Lyons keeps his team focused with e-mails, teleconferences, and clear deadlines.

Still, trying to nurture world-class research outside the U.S. also creates a host of challenges. First was the nervousness of the talent in Niskayuna. They know all

too well that their counterparts in Shanghai and Bangalore are making a fraction of their U.S. salaries, although Sanjay M. Correa, the global technology leader for energy and propulsion at GE Research insists such tensions dissipate once they realize that the new colleagues are additions rather than replacements. With younger employees at the new center there are more questions and less familiarity with the GE way. Still, Ban Phansalkar, a technology leader at the Bangalore center, says “we all speak the same language of technology.”

One way to build team spirit is to foster familiarity. In addition to regular teleconferences, engineers take stints working in other parts of the operation. That has meant trading engineers from Bangalore and Salzbergen, for example, for a week

» Engineers from different countries sometimes trade places for a week or two at a time

or two at a time. Along with learning about the core design tools being created in Bangalore or the actual products being made in Salzbergen, they establish better lines of communication.

The far-flung team is getting results. Among the innovations so far: a new generation of land-based wind turbine with capacities of more than 2.5 megawatts (at a typical price of \$1 million per megawatt) with new blade and advanced control technologies—a boon for customers who want to generate energy on sites where space is limited. GE’s 3.6 megawatt unit, which produces enough electricity to power 1,400 average American homes a year, is designed for offshore locations. Its turbine—without blades each longer than a football field—sits 30 stories above the ocean. Current projects range from a wind farm in Inner Mongolia to working on smaller turbines that could help provide clean water to villages in developing countries. “There are a lot of wild and crazy ideas in the wind industry,” Lyons says with a laugh. “But there is an incredible amount of pent-up demand as well.” And GE staffers around the world are determined to capture as much of that demand as possible. ■

A man in a dark suit and striped tie stands in a museum hallway. To his left is a large, dark-colored dinosaur skeleton, possibly a T-Rex, mounted on the wall. The background shows other museum exhibits and people in the distance.

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The World of Golf



The Ryder Cup: The Venues

When Jesper Parnevik and Tiger Woods putted out the last hole of the final singles match at the Belfry in 2002 – which they halved – they brought down the curtain on Ryder Cup golf in England for at least three and a half decades. Although 15 of the last 17 tournaments staged in Europe have been held in England (four of them at the Belfry), the next three will be played at the K Club in Ireland (in 2006), Celtic Manor in Wales (in 2010) and Gleneagles in Scotland (in 2014). The hosts for the 2008 and 2012 Ryder Cup matches, meanwhile, will be Valhalla in Louisville, Kentucky, and the Medinah Country Club in Illinois.

Although the venues for 2016 and beyond have yet to be announced, it has already been confirmed that with Continental

European golfers playing an increasingly decisive role in the Ryder Cup, the competitions due to be played in 2018, 2022, 2026 and 2030 will all be held outside Great Britain. The result of this year's Ryder Cup fully justifies the move to loosen England's virtual monopoly on hosting the European leg of the competition every four years. After all, Europe's spectacular win was masterminded by a captain from Germany assisted by vice-captains from Sweden and Denmark, with the winning putt sunk by a Scotsman and key singles victories registered by players from Spain, France and the Republic of Ireland.

France, Germany, Sweden and Spain are the most likely candidates to host those contests, with Italy also pushing for consideration. But whichever

Europe's spectacular win was masterminded by a captain from Germany assisted by vice-captains from Sweden and Denmark, with the winning putt sunk by a Scotsman and key singles victories registered by players from Spain, France and the Republic of Ireland – as well as England and Northern Ireland.

locations emerge as the winners, competition between them will be just as fierce as it has been in the past. Increasingly, the intensity of that competition has boiled over into publicly expressed acrimony. Scotland, which insists that it is the Home of Golf, made no pretence of hiding its disgust at the selection of Celtic Manor in South Wales for the 2010 Cup. The Swedish Golf Association, meanwhile, was quoted as saying that the choice of Gleneagles in Scotland for the 2014 event was characteristic of a "lack of respect" for the quality of courses in Continental Europe. Others, meanwhile, responded angrily when British Prime Minister Tony Blair put his personal weight behind the unsuccessful bid made for the 2010 Ryder Cup by Slaley Hall, in the northern English county of Northumberland.

It is not difficult to see why there is such keen competition to host the Ryder Cup among locations that are not blind to its commercial potential, which some say is third only to the

Olympic Games and the soccer World Cup. The proof is in the figures. When the Scottish Executive drew up its case for hosting the Ryder Cup in 2000 (prior to the 9/11 attacks which led to the postponement of the 2001 event), it presented some compelling data. When the European leg of the Ryder Cup was staged outside the British Isles for the first time, in Valderrama in Spain in 1997, it generated income of £56 million (approximately \$90 million) while the 1999 event, at Brookline, Massachusetts, earned about £103 million (\$166 million) for the region, 30% more than had originally been anticipated. Extrapolating those figures, the Scots estimated that a Ryder Cup in Scotland would generate additional spending of £67 million (\$20 million), while the 2006 tournament at the K Club in County Kildare would put about £100 million (\$125 million) of additional tourism revenue into the Irish economy.

Year	Venue	US	Winner
1927	Worcester, Massachusetts	US	USA
1929	Moortown, Leeds, England	Europe	Europe
1931	Scioto, Columbus, Ohio	US	USA
1933	Southport & Ainsdale, England	Europe	Europe
1935	Ridgewood, New Jersey	US	USA
1937	Southport & Ainsdale, England	Europe	USA
1939-45	Competition suspended - World War II		---
1947	Portland, Oregon	US	USA
1949	Ganton, Scarborough, England	Europe	USA
1951	Pinehurst, North Carolina	US	USA
1953	Wentworth, England	Europe	USA
1955	Thunderbird, Palm Springs, California	US	USA
1957	Lindrick, Yorkshire, England	Europe	Europe
1959	Eldorado, Palm Desert, California	US	USA
1961	Royal Lytham & St Annes, England	Europe	USA
1963	East Lake, Atlanta, Georgia	US	USA
1965	Royal Birkdale, Southport, England	Europe	USA
1967	Champions, Houston, Texas	US	USA
1969	Royal Birkdale, Southport, England	Europe	Tied
1971	Old Warson, St Louis, Missouri	US	USA
1973	Muirfield, Scotland	Europe	USA
1975	Laurel Valley, Ligonier, Pennsylvania	US	USA
1977	Royal Lytham & St Annes, England	Europe	USA
1979	Turner Field, West Virginia	US	USA
1981	Wentworth, Surrey, England	Europe	USA
1983	PGA National, Palm Beach Gardens, Florida	US	USA
1985	The Belfry, Sutton Coldfield, England	Europe	Europe
1987	Muirfield Village, Ohio	US	Europe
1989	The Belfry, Sutton Coldfield, England	Europe	Tied
1991	The Ocean Course, Kiawah Island, S.Carolina	US	USA
1993	The Belfry, Sutton Coldfield, England	Europe	USA
1995	Valhalla, Rochester, New York	US	Europe
1997	Valhalla, Sotogrande, Spain	Europe	Europe
1999	The Country Club, Brookline, Massachusetts	US	USA
2001	Competition suspended following 9/11		---
2002	The Belfry, Sutton Coldfield, England	Europe	Europe
2004	Oakland Hills, Michigan	US	Europe
2006	The K Club, County Kildare, Ireland	Europe	
2008	Valhalla, Louisville, Kentucky	US	
2010	Celtic Manor, Wales	Europe	
2012	Medinah Country Club, Illinois	US	
2014	Gleneagles, Scotland	Europe	

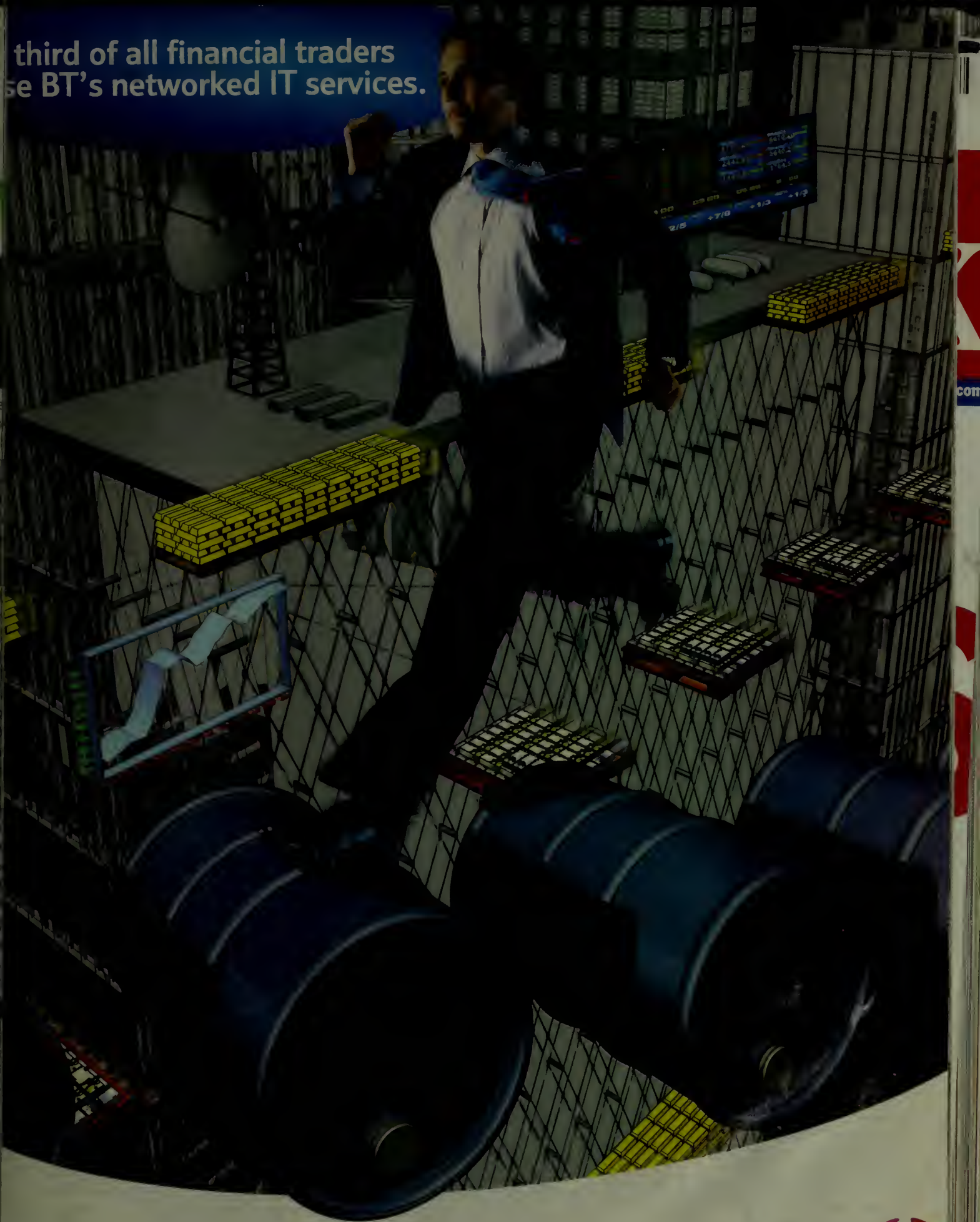
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More power to you

Novel Inspiration

Otherworldly fantasies can evoke solutions to real problems. Science fiction has been honorably doing just that for decades. By Eric S. Rabkin

IN MARCH 1990, MOTOROLA promoted a combination wristwatch and pager with the catchphrase "It's Not Science Fiction Anymore." The ad boasted that Dick Tracy's most famous, futuristic accoutrement was finally within reach. Then the future arrived. Today's palmOne Treo is a telephone, alarm clock, calculator, scheduler, text messenger, and camera. It's also an e-mail client that gives us access to global digital libraries or our own business documents, serves as private device or speakerphone, and beams business cards and applications to nearby colleagues. When we have nothing else to do while stuck in traffic, it can use plug-in modules to reveal our exact position on the planet, suggest alternate travel routes, and offer games to play alone or with friends scattered far across the Net.

The amazing thing is, we don't find this amazing. We're living in a science fiction world. The headlines of our newspapers trumpet cloning experiments, the teleportation of atoms, computers controlled by brainwaves, robots that walk and play musical instruments, private planes that carry passengers to the edge of space, space probes that rendezvous with asteroids, and implantable devices that restore hearing to the deaf. When miracles like these are the baseline, how can fantasy measure up? More simply put: Why on earth should we read science fiction? Here are some of the reasons:

TO MINE NOT-YET-PRACTICAL IDEAS: A science-meets-fiction Web site called Technovelgy.com lists over 650 inventions in the works of 65 science-fiction authors. In the writings of Robert A. Heinlein alone, Technovelgy finds the first appearance of

personal RFID transmitters, robotic appliances, noise-reduction chambers, and the idea of mass-customizing consumer products such as clothes. Among inventions yet to go commercial are pneumatic people movers known as "bounce tubes" and cryogenic sleeping chambers. If we ever colonize the moon, engineers will be taking fresh looks at Heinlein's *The Moon Is a Harsh Mistress* (1966): Colonists send minerals and other commodities back to Earth in huge pods, bound by iron rings, that are accelerated through a series of magnetic boost gates along rails that rise at one end—pointing Earthward.

Arthur C. Clarke was a master of innovation. His *The Fountains of Paradise* (1979) describes a cable system tethered at the Earth's equator and rising to the point where the system's center of gravity maintains a geostationary orbit. That balance point would provide an upper platform for

electric cars running up and down the cable. The cars could carry spacecraft out of the earth's gravitational field, eliminating the need for rocket launches.

Several U.S. startups are now trying to design such a "space elevator," which was first described in the technical writings of Russian engineer Yuri N. Artsutanov in 1960. But it was Clarke's novel that specified the exquisite details, including crystalline carbon fiber for the cable and "spider" construction methods.

Ideas like this one are often born at the border of science fiction and engineering. And the genesis may be blurred further by the fact that many influential fiction writers are accomplished scientists. Robert L. Forward, Gregory Benford, and Vernor Vinge, to name just three. So it's no surprise that novelists, scientists, and engineers may all have a hand in new technologies such as solar sails to power spacecraft on interplanetary flights. The sail idea was shuttled among fictional and technical writings before the Japanese space program actually tested one this summer. Likewise, ideas for "terraforming" Mars to give it a livable atmosphere have long been seriously debated at NASA, where many admire writer Kim Stanley Robinson for the meticulous scientific projections in his 1990s novel

Eric S. Rabkin is a professor of English language and literature at the University of Michigan. His next book is Mars: A Tour of the Human Imagination (Spring, 2005)



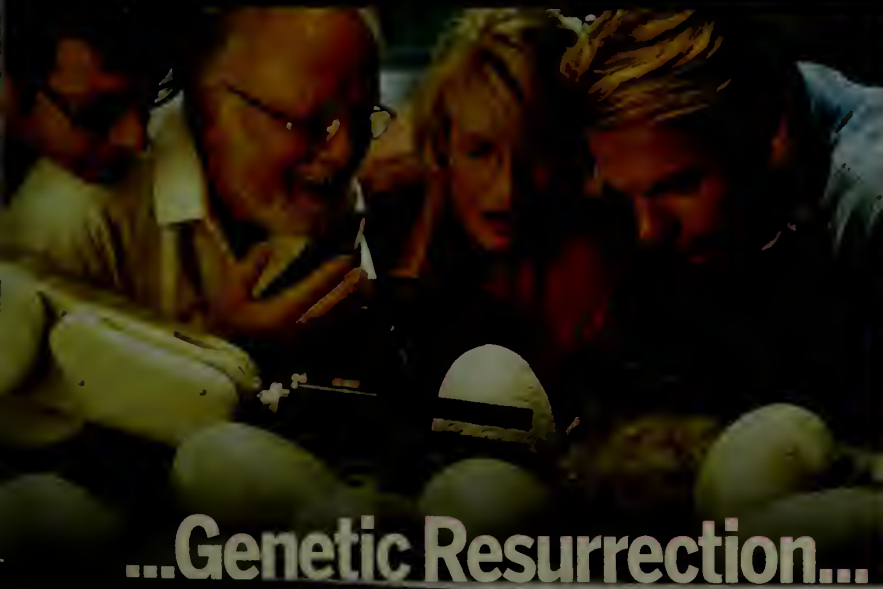
» A cop named Del Spooner (Will Smith) battles a bot called Sonny in this summer's **I, Robot**. The nimble creatures in this film seem to be a few dozen generations more advanced than today's humanoid robots, such as Honda Motor's Asimo, one of the few mechanical bipeds that can navigate stairs.

Robots...



» A teleportation experiment runs amok in **The Fly** (1986), with Jeff Goldblum. Human teleportation may be centuries in the future, but researchers like Christian Roos (right) at the University of Innsbruck, Austria, have succeeded in transferring so-called quantum states from one atom to another—a technique known as quantum teleportation.

...Teleportation...



» In Michael Crichton's **Jurassic Park** (1990), scientists clone dinosaurs using DNA from blood in a mosquito trapped in amber millions of years ago. Last year, at Advanced Cell Technology, scientists cloned an endangered banteng (right) using cells retrieved from an animal that had been dead for several decades. But it has proved extremely difficult to obtain intact DNA from long-lost critters such as woolly mammoths—extinct for about 12,000 years.

...Genetic Resurrection...



...Exoskeletons...

Technical plausibility wasn't a concern when Sony Pictures and Marvel created this version of Doc Ock, the scientist fused with a robot in **Spider-Man 2**. Yet the Pentagon hopes to merge computer science and mechanical engineering to augment human prowess. It has doled out research grants to develop muscular exoskeletons like this one (right), from the University of California at Berkeley, to jack up the carrying capacity of a soldier, fireman, or factory hand.



Red Mars, Green Mars, and Blue Mars.

Earthbound tales of the future also showcase inventions. Many novels, such as Neal Stephenson's *The Diamond Age* (2000), explore nanotechnology. Travelers in Stephenson's world are identified by airborne nanosensors as they enter the gates of fortress cities. Books, in this world, are built of nanoparticles. These books can learn about their readers and modify their contents to better teach or entertain them.

TO LEARN THE LEXICON OF THE FUTURE:

In *The Futurological Congress* (1971), Stanislaw Lem writes that "A man can control only what he comprehends, and comprehend only what he is able to put into words." Karel Capek faced that challenge when he dreamed up humanlike creatures, born in vats, that rise up against their masters in his 1920 play *R.U.R.* He called them robots, derived from the Czech word for labor, and the word entered every major language. In a similar spirit, William Gibson named cyberspace in *Neuromancer* (1984). What words await us? In Alastair Reynolds' *Revelation Space* (2000), people swallow "medichines" that assemble themselves in the body to treat diseases. Ursula K. Le Guin dreamed up "ansibles," devices that use

novel physics to communicate across galaxies. And in Lem's futurology, cops in a "psychemized" society spray a drug called Euphoril for crowd control.

TO EXPLORE SOCIAL CONSEQUENCES: Innovations change our behavior. Trains make us run on time. The automobile begat the highway begat the suburb begat the shopping mall begat children spending time wandering in Consumerland af-

...And More

MIND OVER MATTER

In Theodore Sturgeon's 1953 novel, *More Than Human*, gifted individuals manipulate objects with their minds. Psychokinesis is still a parlor trick, but neuroscientists such as John Donoghue at Brown University and Cyberkinetics can capture and decode brain signals, enabling animals—even humans—to perform tasks on a computer using only their minds.

MACHINE MENTORS

The idea of machines teaching humans goes back to Yevgeny Zamyatin's 1920 dystopic novel, *We*, which inspired both Aldous Huxley and George Orwell. Today, with programs like Cognitive Tutor, from a Carnegie Mellon University spin-off, teaching software can scope out a student's skills and customize the course work to the individual.

STELLAR POWER

David Goodstein's *Out of Gas: The End of the Age of Oil* (2004) describes research on how to collect solar energy in space and transmit it to earth at microwave frequencies, at per-watt costs that could some day be cheaper than fossil fuels. Isaac Asimov articulated that idea in his 1941 short story, "Reason," which was later included in *I, Robot* (1950).

ter school instead of playing in the neighborhood. Science Fiction tells us where such inventions are heading—and where they will take our children. Scientists and engineers may predict, for example, how implants of neurons might confer special abilities. But it takes stories like *Revelation Space* to flesh that out, asking who will be able to afford the implants—and who might be forced to have them.

In *Beggars in Spain* (1991), Nancy Kress imagines a "genemod" technique that makes sleep unnecessary. Instantly, the time available for work and study increases by 50%. Since the treatment is expensive, the advantages are distributed unevenly. The sleepless class evolves over decades into an envied, feared, and sometimes hated minority. Sure enough, today, use of an anti-narcolepsy drug called Provigil, from Cephalon Inc., is spreading among people with no such medical complaint, and more drugs like this are on the way.

And then there is Robinson's *Mars* series. It speculates about the technologies required to terraform a planet so people could live there. But the books also describe a bitter environmental struggle pitting "greens" who believe they have the right to transform Mars against "reds" who will do anything to keep it pristine. Does science fiction really influence everyday events? The U.S. Marine Corps thinks so: Its Commandant's Reading List includes Sun Tzu's *The Art of War* alongside Heinlein's militaristic *Starship Troopers* (1959).

TO INSPIRE YOUNG MINDS: Science fiction not only entertains but also inculcates in young fans a passion for science. Donn Shirley, who managed a billion-dollar Mars Exploration Program at NASA's Jet Propulsion Laboratory, was captivated as a child by Ray Bradbury's *The Martian Chronicles* and Clarke's *The Sands of Mars*. After reading Clarke's serious accounts of space flight, domed cities, and the reshaping of Mars itself, "It was clear to me that space exploration wasn't just fantasy," recalls Shirley, now the director of the Science Fiction Museum & Hall of Fame in Seattle, funded by info tech entrepreneur Paul G. Allen. "I thought, 'Gosh, I could do this.'" In a world where science and engineering can begin to tackle almost any many challenges as the mind can imagine, we need science fiction to bridge the gap: bedazzle us, and make the future real. ■

BusinessWeek online For Eric Rabkin's annotated list of 15 great works of science fiction, please go to www.businessweek.com/75

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COMMENTARY

BY HEATHER GREEN

Are the Copyright Wars Chilling Innovation?

SCIENTISTS LIKE to probe the unknown and pioneer useful technologies. But in the spring of 2001, Edward W. Felten discovered that such efforts aren't always welcome. A computer scientist at Princeton University, Felten took part in a contest sponsored by the Recording Industry Association of America to test technology for guarding music against piracy. He and his students quickly found flaws in the new antipiracy software and prepared to publish their results. But when the RIAA learned of the plan, it threatened to sue under the Digital Millennium Copyright Act (DMCA). Congress passed it back in 1998 to block hackers from breaking copy protection. And they wisely included a provision designed to let researchers such as Felten carry out their important work. Still, the RIAA deemed Felten's line of study too sensitive.

Ultimately, faced with Felten's countersuit, the RIAA backed off. But by that time news of the confrontation had rocked the tech community. The lesson many scientists drew was that copyright protection takes priority over research. "The legal tools that are being used to rein in bad behavior are so blunt that they block a lot of perfectly benign behavior," Felten says. "That worries me."

It's a concern that reverberates broadly in tech circles at a time when Congress is considering tough new antipiracy legislation. Most people agree that the music and film industries have the right to defend themselves against illegal copying. But society needs to consider the potential impact

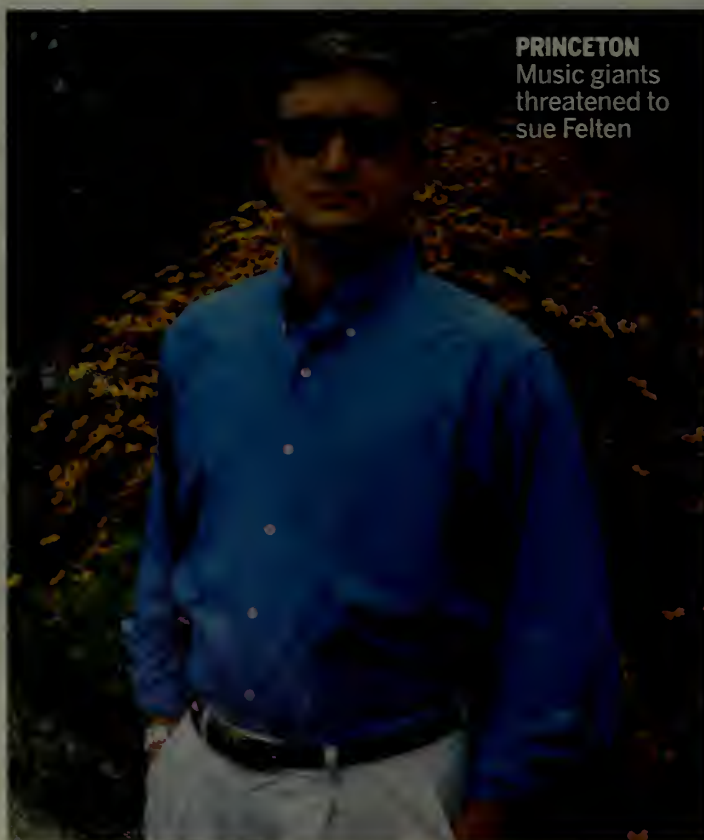
on innovation. Many high-tech business leaders fear that new laws could hobble researchers who are trying to come up with inventions such as next-generation TV systems or even the electronic components for those inventions.

The laws could also intimidate scientists who collaborate using "peer-to-peer" software—already the object of several RIAA lawsuits. You may think of peer-to-peer as the sinister bag of tricks used by services such as KaZaa or Grokster, which let people swap music files stored on their PCs. But such software also happens to be a superb vehicle for disseminating scientific ideas and pooling brainpower. And what if, down the road, souped-up copyright laws trigger a blizzard of lawsuits against academic scientists and inventors? At the very least such litigation could end up sapping university resources and scare away financing for some types of tech startups.

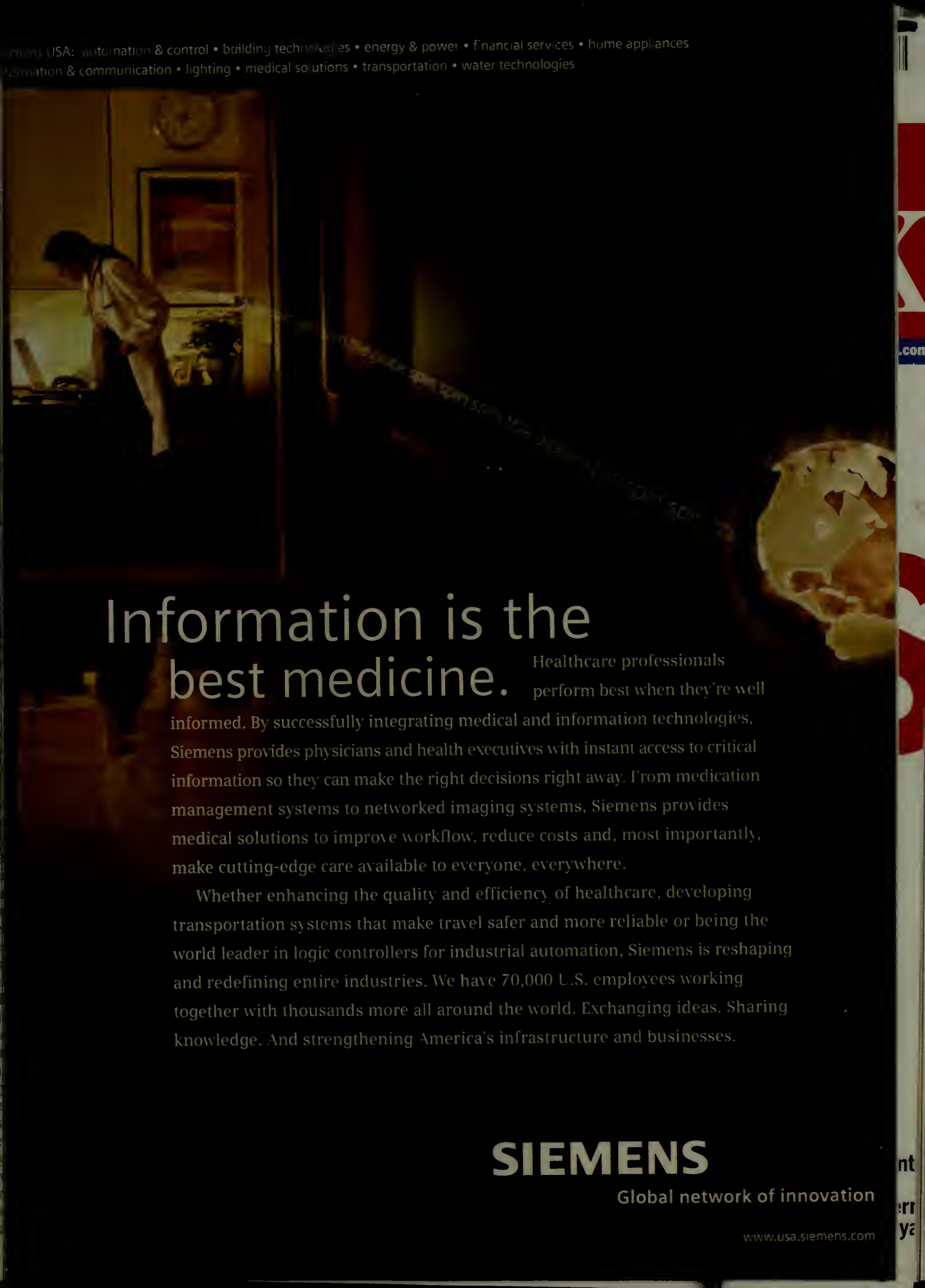
Intimidation isn't hard to spot in academia. Aviel Rubin,

Johns Hopkins University professor who last year uncovered flaws in electronic-voting software developed by Diebold Inc., says he spends precious time plotting legal strategies before publishing research connected in any way to copyright. Matthew Blaze, a computer scientist at the University of Pennsylvania, avoids certain types of computer security-related research because the techniques are also used in copy protection.

The pall has spread over classrooms as well. Eugene H. Spafford, a professor and digital-security expert at Purdue University, and David Wagner, an associate professor of computer science at the University of California at Berkeley, are refusing to take on teaching assignments in certain areas relating to computer security. "The problem isn't that we're worried about prosecution from the government. The problem is the civil lawsuit



PRINCETON
Music giants
threatened to
sue Felten



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» If the “induce” act that media companies want had been law in the '90s, experts say, there would be no iPod

from the movie and music industries,” Spafford says. “I don’t have the resources to deal with that.”

Squabbles over copyrights go back to the dawn of such legislation in the 18th century. Through the decades, courts have struggled to reach a balance between protecting copyrights and ensuring the freedom to create new works. They rarely achieve perfect harmony. But there is a kind of pendulum effect: Enthusiastic lawmakers clamp down too hard, then relax as the technology matures and demonstrates its merits.

Today’s turmoil over copyrights contains a disturbing new twist, however. Digital technology—from MP3 players to software that makes it easy to build Web pages—shatters almost all of the technical barriers to duplicating and sharing copyrighted works. That has caused unparalleled anxiety among copyright holders. As a result, music and movie companies have adopted a strategy of targeting digital technology itself as well as those who design it and those who use it.

In time this could threaten the delicate balance between copy protection and technical innovation. The intent of copyright law in the U.S. is to promote learning and innovation while giving artists, musicians, and writers a limited monopoly on their work. The goal isn’t to assure that artists or intellectuals make oodles of cash.

More recently the courts have been clear: When the government grants a copyright, it isn’t giving recipients permission to control the technology that records or reproduces the work. Nor is it handing them a new way to punish potential infringers. (There are plenty of other legal avenues to battle piracy.) But media companies are so alarmed by the implications of the digital revolution that they’re insisting on a say in the development of recording and playback technology.

Here’s how the effort is playing out: Last fall a group of media companies pushed the Federal Communications Commission to mandate that copy-protection technology be built into some home devices, including DVD systems, TVs, and personal video recorders such as TiVo. The technology, called the broadcast flag, is designed to prevent massive uploading of digital TV broadcasts to the Net.

To assure that tech companies comply, the FCC has obliged them to give regulators and the Motion Picture Association of America (MPAA) a peek at products and technologies under development—and

that’s giving the MPAA more control over how, when, and where people watch TV. This summer, the MPAA coerced companies including RealNetworks, Thomson, and Microsoft to cut innovative features out of their latest media software programs—features that would have allowed users to make legal copies of programs and transmit them over the Net to a limited number of personal devices in, say, a car or a vacation home.

True, the media biz has suffered some setbacks, particularly its attacks on peer-to-peer technology for sharing music or video files. Record companies won a key battle in 2001 when they used a lawsuit to shut down file-sharing pioneer Napster. But when they took on the more sophisticated music-sharing service Grokster and Morpheus this summer, they lost. The Ninth Circuit Court of Appeals in California ruled that the two services, which can be used for legitimate as well as illegal purposes, cannot be expected to control how their users exchange files.

Far from humbled, media companies are moving the fight out of the courts and into the halls of Congress. This summer they pushed for a piece of federal legislation known as the Inducement of Copyrights Act. If it passes, any company or person who “aids, abets, or induces” the illicit sharing of copyrighted works will be liable for copyright infringement.

Some experts warn that broad laws of this sort might restrict legitimate uses for key technologies which could be particularly thorny for young companies that are often the most creative. In the '90s, it was upstarts who developed the first MP3 players, paving the way for a vibrant new market and Apple Computer Inc.’s blockbuster iPod. If the “induce” act had been in place at the time, many legal experts say, the iPod would never have been built.

Critics of the entertainment industry are especially alarmed by assaults on generic technologies, such as peer-to-peer computing. “The popular view is that you must protect the absolute interests of the copyright holder,” says Gregory M. Padopoulos, chief technology officer at Sun Microsystems Inc. “That’s scary because I know it will slam innovation. If you can’t have someone throw together the next great video system for my home because everything is going to be locked down in copyrights, then [breakthroughs by] kids in the garage won’t happen.”

Music and film trade groups deny that their efforts will chill innovative energies. “It’s easy to assert you feel chilled, but don’t see any evidence to support that,” says Fritz Attaway, general counsel for the MPAA. And the record industry is resisting efforts by equipment makers and academics to modify the DMCA. Sen. Joe Biden’s Vice-President Mitch Glazier says softening the act would give pirates a blatant right to hack.

Nobody disputes that digital technology has created unforeseen dilemmas for copyright protection. But changing the laws to target versatile technology and scientific investigation rather than bad behavior is asking society to pay too high a price. ■

The Danger Of Pushing Anti-Piracy Too Far

The movie and music industries are backing rules that hurt the development of new technologies and improved digital security

CURBING INNOVATION

In a worrisome shift, new copyright laws are being written to regulate technology that delivers content. This breaks with the traditional approach: to curb behavior that leads to copyright infringement. New U.S. legislation aimed at illegal file-sharing is written so broadly that it could restrict technologies that underpin MP3 players, instant-messaging systems, and productive file-sharing by corporations and scientists.

UNDERMINING SECURITY

A 1998 law designed to protect digital copyrights makes it a crime to break the digital locks entertainment companies use to protect their music and video wares. Now some computer scientists are hesitating to pursue or publish new methods to improve digital security because they’re worried about being sued.

The truth in 3D

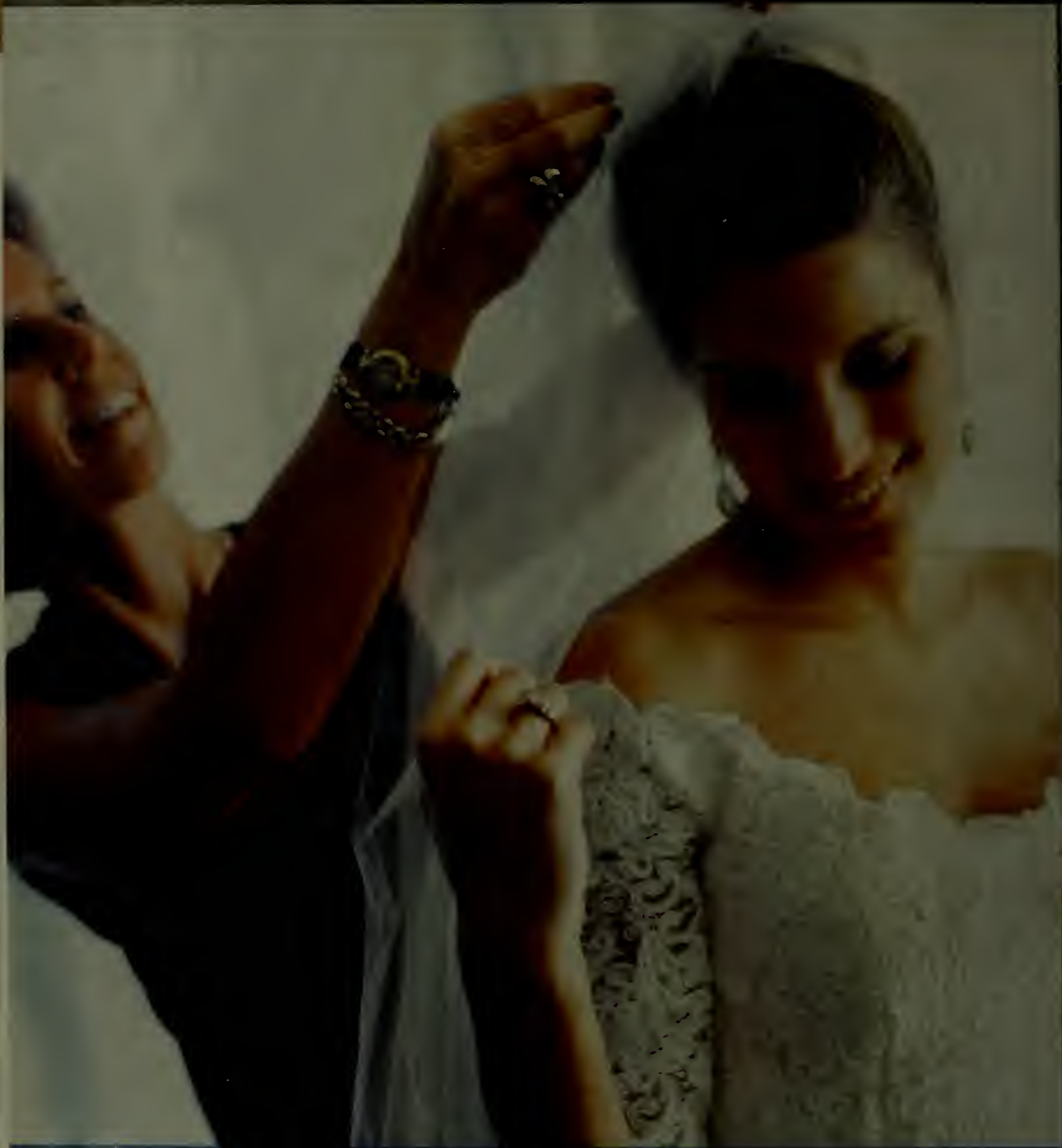
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The Search for Tomorrow

BusinessWeek's new index examines corporate R&D and capital spending. By Peter Coy

WHICH CORPORATIONS are innovating and investing to create future wealth? Which are just coasting? You can tell by looking at their capital spending as well as their research and development outlays. Capital spending gives companies tangible capital such as machinery, while R&D provides them the intangible capital of ideas. Both

are critical. Although R&D and capital spending are usually analyzed one at a time, there's no good reason for that separation.

For this 75th anniversary issue, *BusinessWeek* has devised an index that wraps together R&D and capital spending and calculates the two as a proportion of companies' total outlays. We call it the *BusinessWeek* Investing for the Future Index. It sheds light on which companies—and industries—are devoting the biggest share of their resources to projects whose payoff

lies in the future. The tables, drawn from data supplied by Standard & Poor's Compustat, should be studied in combination with background knowledge of the companies and industries. If a company occupies a niche with lots of profitable opportunities, then strong spending on R&D and capital goods could be a sign of happy days ahead, says Samuel S. Kortum, economist who studies innovation at the University of Minnesota.

The biggest name near the top of the U.S. list, at No. 4, is Amgen Inc. in Thousand Oaks, Calif., the biotech company that makes drugs to fight anemia, arthritis, and cancer. Last year it devoted just over half of its total outlays to future-oriented activities, split roughly equally between R&D and capital spending. Also near the top are another biotech company, Biogen Idec Inc., and two info-tech companies that are spending a big share of their outlays on R&D to build a new generation of products: Applied Micro Circuits Corp. and PMC-Sierra Inc. The top 30's well-established giants include Eli Lilly, Pfizer, Intel, Merck, and Microsoft.

As those names suggest, high-tech companies dominate the index. They continue to see their sector favorably, and they're putting their money to work. All the top 30 U.S. companies except one

The Most Future-Oriented Companies

Corporations have two main ways of investing for the future: research and development, which creates new products and services, and capital spending, which expands capacity through the purchase of new equipment, software, and structures. For the first time, *BusinessWeek* has identified the companies in the Standard & Poor's 500 that spend the biggest portion of their budgets on such future-oriented activities.

COMPANY*	SALES	CAPITAL SPENDING	R & D	TOTAL OUTLAYS**	R & D AND CAPITAL SPENDING AS SHARE OF OUTLAYS	COMPANY*	SALES	CAPITAL SPENDING	R & D	TOTAL OUTLAYS**	R & D AND CAPITAL SPENDING AS SHARE OF OUTLAYS
(MILLIONS OF DOLLARS, MOST RECENT FISCAL YEAR)						(MILLIONS OF DOLLARS, MOST RECENT FISCAL YEAR)					
Applied Micro Circuits	131	13	128	220	64.3%	Merck	22,486	1,916	3,178	14,436	35.3%
Biogen Idec	679	301	233	936	57.1%	National Semiconductor	1,983	215	353	1,617	35.1%
PMC-Sierra	250	12	120	241	54.6%	Adobe Systems	1,295	40	277	906	34.9%
Amgen	8,356	1,357	1,655	5,955	50.6%	Microsoft	36,835	1,109	7,779	25,568	34.8%
BMC Software	1,419	50	586	1,291	49.3%	Comverse Technology	766	35	227	777	33.7%
Gilead Sciences	868	162	165	673	48.5%	Analog Devices	2,047	68	450	1,564	33.1%
Ciena	283	30	213	525	46.1%	QLogic	524	22	88	333	33.1%
Advanced Micro Devices	3,519	570	852	3,341	42.6%	LSI Logic	1,693	78	453	1,638	32.4%
Broadcom	1,610	48	653	1,688	41.5%	Altera	827	14	179	598	32.2%
Genzyme	1,714	260	335	1,508	39.4%	Pfizer	45,188	2,641	7,131	30,707	31.8%
Eli Lilly	12,583	1,707	2,350	10,318	39.3%	Texas Instruments	9,834	800	1,725	8,000	31.6%
Micron Technology	3,091	822	656	3,774	39.2%	Veritas Software	1,747	81	302	1,235	31.0%
Intel	30,141	3,656	4,360	20,645	38.8%	PeopleSoft	2,267	250	433	2,212	30.9%
Chiron	1,644	139	410	1,422	38.6%	eBay	2,165	365	159	1,712	30.6%
Linear Technology	807	21	105	343	36.6%	Tellabs	980	10	286	972	30.4%

Data: Standard & Poor's Compustat



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in drugs and biotech, semiconductors, software and IT services, technology gear, or health care. The lone exception is eBay Inc., the online-auction company, which is classified as a retailer.

BIGGER PICTURE

IT'S COMMON TO rank companies by R&D spending, but that's incomplete. In our ranking, the inclusion of capital spending—on equipment, software, and structures—elevates the status of companies such as Intel Corp., which couples respectable R&D spending with heavy expenditures on new chip-fabrication plants. Another company that gets a big lift from the inclusion of capital spending is eBay, which is investing aggressively in tangible assets even though its R&D expenditures are only middling. Oil producers and manufacturers also look better with capital outlays in the formula.

Capital spending isn't as different from R&D as it might first appear. It isn't

just about adding capacity. It's also a way to stay abreast of the latest developments, since new machines have the latest technology. Capital spending, with R&D, is especially important in nations such as the U.S. and Germany, where high wages demand correspondingly high productivity. "Our society thrives because it produces knowhow," says Stefan Krause, chief financial officer at BMW, the top auto maker on *BusinessWeek's* non-U.S. list.

To compare companies of different sizes, we present R&D and capital expenditures as a share of what we call "outlays." Outlays consist of capital spending plus a broad measure of a company's operating expenses, including salaries, cost of goods sold, and R&D, and excluding such items as depreciation and acquisition costs. Expressing R&D and capital spending as a share of outlays (rather than as a share of revenue) shows how companies choose to break down their spending regardless of

whether their sales are high or low.

Covered in the initial two tables are the largest companies in the U.S. The database is the Standard & Poor's 500, which represents 82% of the market value of all U.S. companies worth \$1 billion or more. Since innovation is a global business, we also wanted to look at which non-U.S. businesses are more future-oriented, based again on Standard & Poor's database. Outside the U.S., the database is the roughly 700 non-American members of the S&P 1200—namely, most of the large foreign companies for which it is easy to obtain complete financial data. The tables list only companies that report both capital spending and R&D as separate line items in their financial reports. No financial companies break out R&D, nor do most U.S. utilities and retailers, so they're omitted from the ranking.

For additional insight, *BusinessWeek* looked at rankings within industries. Eastman Kodak Co., spending heavily

Leaders By Sector

Here are the U.S. companies, by S&P 500 sector, that reported the highest research and development and capital spending (as a share of total outlays).

INDUSTRY*	SALES	CAPITAL SPENDING	R & D	TOTAL OUTLAYS**	R&D AND CAPITAL SPENDING AS SHARE OF OUTLAYS
(MILLIONS OF DOLLARS, MOST RECENT FISCAL YEAR)					

AUTOS & COMPONENTS

Delphi Corp.	28,096	1,005	2,000	27,377	11.0%
Ford Motor	164,196	7,749	7,500	149,532	10.2%
Harley-Davidson	4,904	227	150	3,767	10.0%

CAPITAL GOODS

ITT Industries	5,627	154	559	5,033	14.2%
Power-One	256	7	29	261	13.7%
Rockwell Collins	2,542	72	216	2,174	13.2%

CONSUMER GOODS

Eastman Kodak	13,317	506	750	11,975	10.5%
Mattel	4,960	200	167	4,179	8.8%
Hasbro	3,139	63	143	2,693	7.7%

DRUGS & BIOTECH

Biogen IDEC	679	301	233	936	57.1%
Amgen	8,356	1,357	1,655	5,955	50.6%
Gilead Sciences	868	162	165	673	48.5%

ENERGY

Occidental Petroleum	9,326	1,601	7	6,566	24.5%
Schlumberger	13,893	1,175	556	12,462	13.9%
Baker-Hughes	5,293	405	173	4,741	12.2%

FOOD, BEVERAGE, & TOBACCO

General Mills	11,070	628	158	9,245	8.5%
Hershey Foods	4,173	219	25	3,397	7.2%
Campbell Soup	6,678	283	88	5,588	6.6%

INDUSTRY*	SALES	CAPITAL SPENDING	R & D	TOTAL OUTLAYS**	R&D AND CAPITAL SPENDING AS SHARE OF OUTLAYS
(MILLIONS OF DOLLARS, MOST RECENT FISCAL YEAR)					

HEALTH CARE

Guidant	3,699	249	518	2,741	28.0%
Boston Scientific	3,476	188	452	2,719	23.5%
Medtronic	9,087	425	852	5,888	21.7%

HOUSEHOLD PRODUCTS

Kimberly-Clark	14,348	878	281	11,943	9.7%
Procter & Gamble	51,407	2,024	1,802	41,871	9.1%
Gillette	9,252	408	202	6,892	8.9%

MATERIALS

Praxair	5,613	983	75	5,152	20.5%
Monsanto	4,936	206	510	3,994	17.9%
Intl. Flavors & Fragrances	1,902	66	159	1,553	14.5%

SEMICONDUCTORS

Applied Micro Circuits	131	13	128	220	64.3%
PMC-Sierra	249	12	120	241	54.6%
Advanced Micro Devices	3,519	570	852	3,341	42.6%

SOFTWARE & SERVICES

BMC Software	1,419	50	586	1,291	49.3%
Adobe Systems	1,295	39	277	906	34.9%
Microsoft	36,835	1,109	7,779	25,568	34.8%

TECHNOLOGY HARDWARE

Ciena	283	30	213	525	46.1%
Comverse Technology	766	35	226	777	33.7%
QLogic	524	22	88	333	33.1%

* Some companies in the S&P 500 don't report R&D spending. ** Total outlays include capital spending and R&D. Data are for the most recent fiscal year ended June 30, 2004. Source: Standard & Poor's Compustat. *BusinessWeek*.



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to make the leap to digital imaging, was No. 1 in consumer goods, topping the likes of Mattel Inc. and Hasbro Inc. In capital goods, No. 1 is a company that's sometimes still thought of as a low-tech conglomerate: ITT Industries Inc. in White Plains, N.Y. The new, streamlined ITT conducts R&D in such fields as military night-vision gear and avionics.

Overseas, in the auto industry, Japan's vaunted carmakers are outranked by Germany's BMW and Volkswagen. In software, the highest-ranked non-U.S. company is France's Dassault Systèmes, which makes industrial-design software.

WHEN TO SCALE BACK

MORE ISN'T ALWAYS better. Companies in slower-growing, low-wage service sectors such as retailing would be foolish to match the future-oriented spending of, say, software or biotech. And heavy spending can indicate wasteful empire-building, notes Louis K.C. Chan, a finance professor at the University of Illinois at Urbana-Champaign who has studied the topic. Some fund managers look askance at companies that do lots of speculative research. "I'm a bigger fan of the Dell model, including a tight R&D budget," says Daniel Niles, CEO of Neuberger Berman Technology Management.

In industries such as pharmaceuticals, throttling back R&D isn't an option. Pfizer Inc., for example, hasn't had a blockbuster drug it developed itself since Viagra in 1998, yet it keeps plugging away. With drugs going off-patent only seven or eight years after they finally reach the market and senior management seeking 10% annual growth in revenue and profit, "you need to reinvent yourself every decade and double in size," says John L. LaMattina, Pfizer's president for global research and development.

Microsoft has an easier task than Pfizer because its future revenues are more reliable. But it spends heavily on R&D, too. The software giant wants to pioneer information technologies and not just dominate ones other companies have debuted. Chairman William H. Gates III told analysts in July that Microsoft is making "a bet" based on "a very serious belief that innovation investments will pay off in a very dramatic way."

Sure, big bets don't always pay off. But the future belongs to companies that ante up for capital spending and R&D—and manage to turn their tangible and intangible capital into real wealth. ■

—With Ben Elgin in San Mateo, Calif.,
Amy Barrett in Philadelphia,
and Gail Edmondson in Munich

Investing for the Future Globally

Using S&P's database of large, non-U.S. companies, *BusinessWeek* has identified the ones in each sector that report the highest R&D and capital spending as a share of total outlays.

INDUSTRY*	COUNTRY	SALES	CAPITAL SPENDING	R&D	TOTAL OUTLAYS**	R&D AND CAPITAL SPENDING AS SHARE OF OUTLAYS
(MILLIONS OF DOLLARS, MOST RECENT FISCAL YEAR)						
AUTOS & COMPONENTS						
Denso	Japan	23,459	1,711	1,968	22,059	16.7%
BMW	Germany	50,216	4,976	2,595	48,302	15.7%
Volkswagen	Germany	105,394	10,747	4,264	105,781	14.2%
CAPITAL GOODS						
BAE Systems	Britain	14,912	432	3,046	13,758	25.3%
Matsushita Electric	Japan	11,289	2,523	484	12,921	23.3%
CAE	Canada	821	71	70	744	19.0%
CONSUMER GOODS						
Pioneer	Japan	6,417	517	471	6,159	16.1%
Fuji Photo Film	Japan	23,441	1,808	1,587	22,016	15.4%
Sharp	Japan	20,666	1,656	1,271	19,821	14.8%
DRUGS & BIOTECH						
Biovail	Canada	800	36	205	470	51.2%
Serono	Switzerland	1,858	163	468	1,453	43.4%
Elan	Ireland	762	34	331	944	38.7%
ENERGY						
CNOOC	Hong Kong	3,399	1,495	20	2,449	61.9%
PetroChina	China	36,718	9,804	291	29,165	34.6%
BG Group	Britain	6,377	1,136	14	4,845	23.7%
FOOD, BEVERAGE, & TOBACCO						
Interbrew	Belgium	8,518	658	17	7,386	9.1%
Ajinomoto	Japan	9,517	448	258	9,003	7.8%
Cadbury Schweppes	Britain	11,452	544	94	9,517	6.7%
HOUSEHOLD PRODUCTS						
KAO	Japan	8,264	402	353	7,037	10.7%
Uni-Charm	Japan	2,198	166	43	1,977	10.6%
L'Oreal	France	16,965	675	580	14,720	8.5%
MATERIALS						
Vale Do Rio Doce	Brazil	5,350	1,543	82	5,011	32.4%
Inco	Canada	2,474	591	27	2,549	24.2%
Rio Tinto Group	Australia	9,228	1,533	23	8,183	19.0%
SEMICONDUCTORS						
ARM Holdings	Britain	228	6	86	170	53.9%
United Microelectronics	Taiwan	2,758	739	174	1,990	45.9%
STMicroelectronics	Netherlands	7,234	1,221	1,238	6,312	39.0%
SOFTWARE & SERVICES						
Dassault Systèmes	France	913	19	261	617	45.4%
SAP	Germany	8,495	333	1,202	6,482	23.7%
Sage Group	Britain	996	73	103	771	22.8%
TECHNOLOGY HARDWARE						
Murata Manufacturing	Japan	3,793	301	313	3,006	20.4%
Ericsson (LM) Telefon	Sweden	19,322	363	3,888	21,335	19.9%
Spirent	Britain	829	30	117	743	19.8%

*This table identifies the roughly 700 non-U.S. companies that are part of the Standard & Poor's Global 1200. The large-cap index includes about 250 companies from Europe, 100 from Japan, 60 from Canada, 50 each from Australia and non-Japanese Asia, and 40 from the U.S. Data is available for only about 300 of the companies. Fiscal years ended on or before June 30, 2004.

**Outlays include capital spending plus a broad measure of operating expenses, including R&D.

Data: Standard & Poor's Financial Statistics, BusinessWeek



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COMMENTARY

BY MICHAEL J. MANDEL

How to Sharpen The Innovation Edge

OVER THE PAST 75 YEARS, economists have learned much about managing a market economy. They've mastered policies for avoiding depressions and ameliorating recessions; they've plotted strategies for keeping inflation under control and for responding to financial crises. Yet when it comes to encouraging innovation—one of the most essential ingredients for economic growth—there still is little consensus about what to do. Some

economists say that the key is to cut the nation's budget deficit to unlock more funds for private-sector research and development, while others favor slashing taxes to provide more incentives for entrepreneurs. Some advocate strengthening patents and copyrights to give innovators a good payoff on their ideas. Others worry that too much protection of intellectual property will increase litigation and slow innovation.

Part of the difficulty in identifying the right policy is that the innovation economy has many moving parts. The government, universities, big companies, small startups, venture-capital firms, stock market investors—each has a distinct role. And innovation has gone global, bringing in even more players.



There is one guidepost amid the confusing trends: the enormous and surprising success of the American innovation machine in recent years. In the late 1980s and the early 1990s, virtually all economic forecasters wrote off the U.S. as a mature, slow-growth laggard that eventually would be passed by more vibrant economies in Europe and Japan. Yet when the Internet revolution arrived, it was U.S. entrepreneurs who proved far more nimble and adept in converting ideas into products. The result was a productivity boom that is still barreling forward.

Governments around the world should be able to build on the successes of the 1990s. Here are some ideas for spurring innovation:

INVEST IN RESEARCH AND EDUCATION Innovation depends on good ideas and smart people. So, to encourage innovation over the long run, the best course is to increase government funding for basic research, which is not profitable for most companies, and to spend more on graduate education in science and engineering.

In recent years, the U.S. has had a reasonably good record in these areas. Since 1997, federal government contributions for basic research, adjusted for inflation, have risen at a 6.8% annual rate, outpacing the growth of the economy as a whole. And graduate enrollment in science and engineering rose by 12% from 1997 to 2002, the last year for which data are available.

But more is needed. In the aftermath of September 11, there's been understandable pressure to shift resources towards defense and homeland security. Real federal spending on basic research has stalled out, with no rise likely in fiscal year 2005. And tighter security procedures have made it much harder for foreign students and researchers to get visas, with no sign yet that Americans are making up the slack.

That's why putting more financial muscle behind basic research and education in graduate science and engineering is essential, not just in the U.S. but around the world. "Most governments should do more to encourage investment in R&D," says Elhanan Helpman, a Harvard University economist and growth expert. "Sometimes simple things do a good job."

GET THE MAXIMUM BENEFIT FROM GLOBAL INNOVATION For the first time ever, innovation is spreading from a few large industrial countries to a broader stage. That's good news: The rise of higher education and R&D spending around the world can create a global division of labor where the U.S. specializes in areas such as biotech and advanced software while South Korea and Taiwan focus on areas such as flat-panel displays and chips.

Countries have to take two steps to fully participate in the

WALL STREET
Security spending may divert resources from R&D

new global innovation economy. First, they need to be willing to engage in collaborative research across national boundaries, and allow the free movement

of ideas and people. Building up walls around intellectual property is simply a bad idea.

Second, to make the best use of innovations elsewhere, a country, including the U.S., has to spend enough on R&D and education to maintain a substantial presence in critical fields of research, including the ones where it is not the leader. That's the ante to get into the global game.

SUPPORT THE PATENT OFFICE A well-functioning patent office is key in an Innovation Economy. In the U.S., however, it's not working very well. Since 1997, the number of patent applications has risen by 50%, but the backlog

of patents waiting for action by a patent examiner has quadrupled. Moreover, Congress, desperate for funds to reduce the budget deficit, has not allowed the Patent & Trademark Office to spend all the money brought in by application fees. "The patent office has been transformed into a profit center," says Joseph Lerner, a professor at Harvard Business School.

Faced with a mountain of applications, patent examiners are compounding the problem by approving patents too quickly, and giving protection to far too many broad or mundane ideas. The result, says Lerner, is a "litigation tax" on innovation, which forces new companies to spend time and

A Four-Point Plan For Progress

How governments and decisionmakers around the world can spur innovation:

Invest for the Future

To encourage innovation, developed and emerging nations must devote more resources to research and development and to graduate education in science and engineering. The U.S., especially, must ramp up spending if it wants to keep its leading-edge role.

Take Advantage of the Global Economy

The fears of terrorism and of losing jobs can endanger innovation by slowing the flow of goods, people, and ideas across national boundaries. The U.S. should reemphasize its longtime commitment to an open global economy and ensure that skilled immigrants and students can still enter the country.

Provide the Right Protection for Intellectual Property

The toughest long-term issue is finding a proper balance between too much and not enough protection of intellectual property, both of which can impede creativity. At a minimum, the U.S. and other countries should give their patent offices enough funds to make better decisions.

Emphasize Innovation as a High Priority

Politicians pay lip service to innovation, but it is rarely a top economic policy goal. To make it easier to muster popular support for future-oriented programs, official economic statistics must be improved to properly measure the benefits of innovation and not just the costs.

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Industry and Academia Weigh In

In December, the Council on Competitiveness—an organization of CEOs, university presidents, and labor leaders—will release the recommendations from its yearlong National Innovation Initiative. The goal of the initiative is to identify key steps the U.S. should take to keep its leading role as an innovator in the global economy.

BusinessWeek's Michael Mandel and Steve Hamm spoke with the co-chairs of the initiative: Samuel J. Palmisano, CEO of IBM, and G. Wayne Clough, president of Georgia Institute of Technology. Here's an excerpt from that conversation:

There are some areas of research and development where the U.S. is weaker than it should be.

CLOUGH: With the Cold War going away, some of the motivations for R&D funding shifted dramatically. In the process of that, people were not thinking very clearly about the mix.

We know there's a problem. You've got to get Energy Dept. support up. You've got to get the Defense Dept. back in the basic research game, and you've got to get some more funding to the National Science Foundation. And you need to create a [new] National Defense Education Act, which will fund scholarships and fellowships for American students to go to graduate school.

How can the U.S. make sure that we have the skilled workforce we need?

PALMISANO: A lot of what companies do—and we happen to be an example of it—is try to get more and more diverse groups interested in technical fields. We understand that if you just look at the pipeline, we can't fill the number of jobs we need strictly with the majority groups.

So we're trying to get younger people earlier on in their lives excited about technology. There's multiple forms of engineering disciplines, so we're not trying to steer them into computer science or a program that they might find uninteresting.

CLOUGH: We created a major called

human/computer interaction. And what does that do? It draws in a lot of women and minorities—which computer science doesn't.

Innovation thrives on openness, which seems to be more difficult today.

PALMISANO: We're going to really try to articulate the importance of global interaction. We don't think any country, and the U.S. being the most advanced, can now build up walls like we're some big castle.



SUMMING UP Palmisano (left) and Clough

Quite honestly, we've learned at IBM that we get much better output, or quality of innovation, by having these global interactions.

The report is supposed to come out in mid-December?

CLOUGH: One of the reasons we're choosing December was you're going to have an Administration in transition, even if it's the existing Administration. We have heard from both campaigns that they want advice on this.

PALMISANO: We really think that our work begins after the report is published in December. We're going to have to push, lobby, educate, articulate, persuade, nudge—all the things you have to do to make this thing a reality.

BusinessWeek online For more from the Palmisano-Clough interview, go to www.businessweek.com/75

money wending their way through a forest of existing patents before they can launch a new product.

The right level of protection for intellectual property is a divisive subject. Perhaps the simplest fix is to give the patent office more funding, including allowing it to tap its own funds. More examiners, and more time to look into what has been done before—"prior art"—may improve the quality of patent grants.

BETTER NUMBERS ON INNOVATION An Innovation Economy requires political support to prosper. Politicians have to speak in favor of investments in new technologies that may not pay off for years.

It's easier to muster support for innovation with concrete evidence of its positive effects. Unfortunately, the government's statistical system typically does much better job measuring old technologies and industries than it does measuring new ones, so it can take years before an innovation is fully reflected in the data.

For example, the first single-chip microprocessor was introduced by Intel Corp. in 1971, triggering a period of rapid decreases in the price of computing power. But that wasn't measured by the government until 1985.

Today, the statistical system needs to be retooled again to better quantify the impact of such health-care innovation as new drug

and surgical techniques. The cost of the health-care sector today is well counted but there's no good measure of its true output, which is years of good health. That makes it much harder to assess the payoff from the billions of dollars spent on medical research.

MAINTAIN FREE MARKETS The rapid innovation of the past 75 years has been accompanied by the spread of the market-based economic system around the globe. In terms of innovation, this is no coincidence. "The historical record shows that this is the one system that has worked," says Northwestern University economic historian Joel Mokyr.

It is far easier to protect the status quo than it is to adopt the policies that promote change and innovation. Yet in the end, it is competition and free market that spur innovation—and that is what will make the next 75 years as fruitful as the past 75. ■

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BY ROBERT BARKER

A Blockbuster Offer With Little Star Power

As Viacom's CBS News flounders in humiliation over its report on President Bush's National Guard service, the damage to this prized asset might be a shareholder's top worry. Yet investors face a more pressing issue: Should they swap their Viacom stock for shares in Blockbuster, its chain of movie- and game-rental outlets? Viacom's offer expires on Oct. 5, and it has investors such as Jerome Donovan, of New Hartford, N.Y., asking if Viacom "is dumping a declining business" or simply refocusing on its main television, radio, and film operations.

That's no simple question, as the hundreds of pages filled with figures and legalese that Viacom dropped on its stockholders make plain. Much of the gobbledygook is designed to keep the deal tax-free, but it all boils down to this: Viacom, which bought Blockbuster in 1994, took it public in 1999 but kept a majority stake. Now it's telling Viacom investors that, for each Viacom share handed in, they'll get 5.15 shares in Blockbuster. If the deal goes as hoped, Viacom will wind up handing its entire stake in Blockbuster to the public while cutting its own shares outstanding by 1.6%—a neat way to lift its future earnings per share.

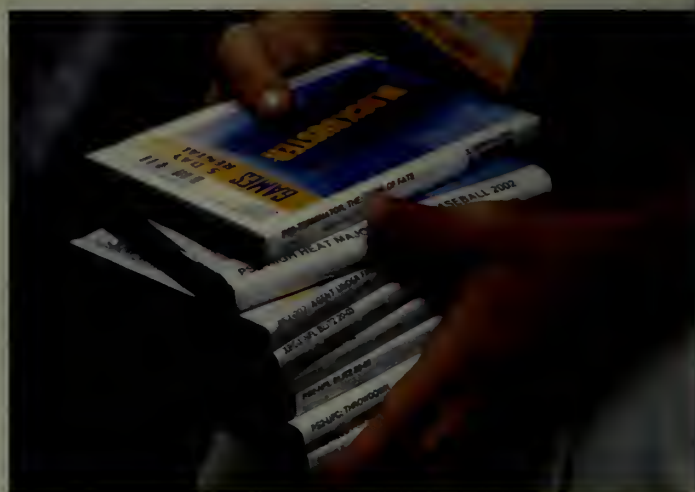
THE SIMPLEST THING to do is nothing. But the relative values of the two stocks make Blockbuster seem enticing. A share of Viacom, recently worth \$33.11, would bring 5.15 shares of Blockbuster worth \$37.90—a 14.5% premium. Yet that spread has already narrowed since the deal's terms were disclosed (table). It may narrow more as the actual exchange nears. You probably wouldn't buy stock in Blockbuster for its current results, which are being hurt by the decline in the movie-rental business as consumers choose to buy more and more titles on DVD. In the first half, revenues rose a tad, to \$2.9 billion. But with heavy investment in such new initiatives as Blockbuster Online, which is aimed at competing with Internet DVD rental service Netflix, cash flow after capital spending dried up. Free cash flow in the first half came to a negative \$9.6 million.

Boffo?

Viacom wants to swap 5.15 Blockbuster shares for each of its Viacom shares

DATE	PREMIUM*
Sept. 7	19.2%
Sept. 27	14.5

*% of Blockbuster shares over 1 Viacom share
Data: Dow Jones & Co. / Bloomberg



A year ago there was \$88 million in cash left after capital projects. The company has not forecast free cash flow for the full year, but it expects net income to fall 30% or more, to perhaps \$1.03 a share. When I asked CEO John Antioco if the year's financial results will prove to be a nadir, he was careful not to go that far. He did say, however, that Blockbuster will end most of its spending on new projects—creating stores-within-stores for video gamers, a DVD trading-and-resale initiative, plus the online service—in 2005. After that he sees Blockbuster as able to create \$200 million to \$300 million in free cash flow a year.

If Antioco turns out to be right, then Blockbuster's current stock market value of \$1.3 billion would be only six or so times free cash flow in 2006—dirt cheap. And Viacom? With \$27.7 billion in revenue over the past four quarters, it boasts much larger stock market value of \$58 billion. Last year free cash flow came to \$3 billion, and as Viacom's sales of TV advertising rebound this year, it's growing smartly, up nearly 24%, to \$1.8 billion, in the first half. At that rate, Viacom is trading near 16 times this year's free cash flow—squarely between such major rivals as Walt Disney and Time Warner.

So Blockbuster is a much riskier bet, and the market is pricing it as such. To give up stock in Viacom, with its variety of revenue sources and greater certainty of returns, you would have to believe that Blockbuster will be able to fend off not just Netflix but also sales of DVDs by the likes of Wal-Mart Stores—while also competing with the onrush of technology such as video on demand. It may. Yet after weighing the odds, most shareholders will likely do with Viacom's offer what Jerome Donovan did: toss it in the trash. ■

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BY GENE G. MARCIAL

A CAR-PARTS DEAL WITH FORD OR GM COULD SPEED UP STANDARD
ADVANCED MEDICAL OPTICS SEES A WIDER MARKET FOR LENSES.
HOW THEY'RE DRAWING A BEAD ON ALZHEIMER'S AT AXONYX.

Standard Guns its Engine

STANDARD MOTOR PRODUCTS (SMP) is in a humdrum business: replacement car parts. But the stock action is exciting. Since November, shares have leaped from 9 to nearly 15 despite a lack of Street support. Of the big firms, only Goldman Sachs follows it: Goldman did a stock offering for Standard last year, at 10. But now it rates the stock "underperform," based on earnings and long-term prospects. Some pros disagree. Rodney Hathaway, who heads Heartland Value Plus Fund, which owns shares, is upbeat on Standard and sees it hitting 25 in a year. And Mario Gabelli, whose mutual-fund group owns 14%, foresees big earnings gains. Standard makes ignition and emission-control systems, onboard computers, and air-and-heating units. Its big rivals—Delphi and Visteon—supply General Motors and Ford Motor, respectively, for both new cars and the aftermarket. But their contracts are up for renewal, so Hathaway sees Standard snatching part of the GM-Ford aftermarket business. Why? Its costs are low (with nonunion labor), and it can make parts in small batches. Hathaway figures Standard can up sales by \$50 million in each of the next three years. Longer term, he says this new business could lift the total a further 8% to 10%. He sees earnings (without any GM-Ford business) of \$1.05 on sales of \$830 million in 2004; \$1.70 on \$845 million in 2005; and \$2 on \$875 million in 2006—way above 2003's 1¢, on \$678 million.

MAKING PROGRESS

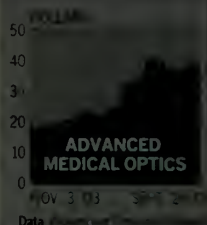


Clear Vistas at Advanced Medical Optics

ADVANCED MEDICAL OPTICS (AVO) isn't a household name, but it's a global leader in products for ophthalmic surgery and eye care. Spun off by Allergan in 2002, the company makes devices for cataract and refractive surgery, including intraocular lenses. Its stock hit a 52-week high of 43 in late June, up from 17 in November. But it has since slipped to 38. Is it downhill from here? By no means, says Joanne Wuensch of investment firm Harris Nesbitt, who rates the stock "outperform" and sees it at 46 in a year. After a strong run, she says, "it is pausing before a further ascent." The pause, Wuensch adds, is due in part to the purchase in June of Pfizer's ophthalmic business. The deal makes sense for Advanced, she

says. It will boost its product line and fatten profit margins. Mike Lachman of ThinkEquity Partners rates the stock "overweight" and figures added sales from the acquired unit in 2005 will be \$145 million, assuming no growth. Wuensch sees pro-forma profits of \$1.23 in 2004 on sales of \$734 million, \$1.70 on \$851 million in 2005, and \$2 on \$905 million in 2006.

ON A HIGH PLATEAU



Can Axonyx Help Treat Alzheimer's?

TINY AXONYX (AXYX) could join Pfizer, Johnson & Johnson, Novartis, and Forest Labs in the Alzheimer's fight. In the past six years, Axonyx has developed drugs to battle cognitive disorders, notes Elmer Piros, top biotech analyst at Rodman & Renshaw, which owns shares and has done banking for Axonyx. "It heads my list in biotechs," he says, based on its Phenserine, other drugs in its pipeline, and \$93 million cash hoard. Phenserine, now in two Phase 3 (large sample) trials, "could be a blockbuster," says Piros. He notes that in pre-clinical experiments, "it lowered, without toxicity, beta-amyloid"—thought to be a factor in Alzheimer's. So Phenserine may "not only treat the symptoms of Alzheimer's, as existing drugs do, but could alter the course of neurodegeneration and slow or halt Alzheimer's," he adds. "Results of one trial will be out in January," says Dr. Marvin Hausman, CEO of Axonyx, who expects them to be "positive." Piros says Phenserine sales could eventually hit \$400 million to \$1.8 billion a year depending on how successful the results. Piros wouldn't be surprised if big drugmakers made a bid for Axonyx. Hausman, the top shareholder, with 4.5%, insists Axonyx isn't for sale. Second-largest holder is Barclays, with 4.2%. Axonyx, which has yet to have sales, is trading at 5.25. ■

STILL IN A LULL



BusinessWeek online Gene Marcial's Inside Wall Street is posted at businessweek.com/today.htm at 5 p.m. EST on the magazine's publication day, usually Thursdays. See Gene on Fridays at 1:20 p.m. EST on CNNfn's *The Money Gang*.

Note: Unless otherwise noted, neither the sources cited in Inside Wall Street nor their firms hold positions in the stocks under discussion. Similarly, they have no investment banking or other financial relationships with them.

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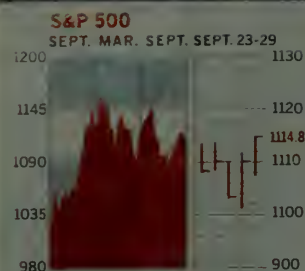
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Personal Business Figures of the Week

STOCKS



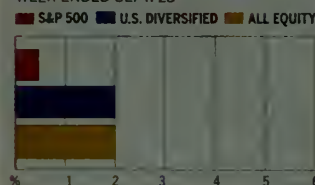
COMMENTARY

Stocks ended fractionally higher in spite of oil, which edged near \$50 a barrel for most of the week, and news that consumer confidence fell in August for the second month in a row. The U.S. housing market continued to surge, with new-home sales soaring 9.4% in August. Volume on the bourses was light as buyers remain cautious ahead of the upcoming earnings season.

Data: Bloomberg Financial Markets, Reuters

MUTUAL FUNDS

4-WEEK TOTAL RETURN



52-WEEK TOTAL RETURN



Data: Standard & Poor's

U.S. MARKETS

	SEPT. 29	WEEK	% CHANGE YEAR TO DATE	LAST 12 MONTHS
S&P 500	1114.8	0.1	0.3	10.8
Dow Jones Industrials	10,136.2	0.3	-3.0	8.1
NASDAQ Composite	1893.9	0.4	-5.5	3.8
S&P MidCap 400	589.0	0.3	2.3	14.6
S&P SmallCap 600	291.2	1.3	7.7	22.7
DJ Wilshire 5000	10,886.2	0.2	0.8	11.7

SECTORS

	SEPT. 29	WEEK	% CHANGE YEAR TO DATE	LAST 12 MONTHS
BusinessWeek 50*	648.5	0.1	4.2	10.9
BW Info Tech 100**	326.1	-0.3	-6.9	1.3
S&P/BARRA Growth	540.5	0.3	-2.8	5.0
S&P/BARRA Value	570.2	0.0	3.3	16.7
S&P Energy	275.3	0.1	22.8	40.0
S&P Financials	384.0	-0.3	1.1	11.4
S&P REIT	126.4	0.2	9.1	17.9
S&P Transportation	208.6	1.7	3.3	16.3
S&P Utilities	127.0	-0.3	7.3	14.0
GSTI Internet	149.2	2.5	3.2	9.6
PSE Technology	676.8	0.0	-2.9	8.0

*Mar. 19, 1999=1000 **Feb. 7, 2000=1000

GLOBAL MARKETS

	SEPT. 29	WEEK	% CHANGE YEAR TO DATE	LAST 12 MONTHS
S&P Euro Plus (U.S. Dollar)	1183.3	0.1	0.4	2.1
London (FT-SE 100)	4588.1	-0.1	2.5	10.1
Paris (CAC 40)	3682.7	-0.3	3.5	11.1
Frankfurt (DAX)	3920.4	-0.6	-1.1	18.1
Tokyo (NIKKEI 225)	10,786.1	-2.7	1.0	5.1
Hong Kong (Hang Seng)	12,950.8	-2.7	3.0	16.1
Toronto (S&P/TSX Composite)	8634.1	0.6	5.0	16.1
Mexico City (IPC)	10,980.3	1.9	24.8	4.1

FUNDAMENTALS

	SEPT. 28	WEEK AGO	YEAR AGO
S&P 500 Dividend Yield	1.74%	1.69%	1.67
S&P 500 P/E Ratio (Trailing 12 mos.)	19.7	20.0	27.6
S&P 500 P/E Ratio (Next 12 mos.)*	16.3	16.6	16.7
First Call Earnings Revision*	-0.60%	-0.49%	0.83

*First Call Co.

TECHNICAL INDICATORS

	SEPT. 28	WEEK AGO	REAL TIME
S&P 500 200-day average	1117.7	1116.6	Negative
Stocks above 200-day average	57.0%	60.0%	Neutral
Options: Put/call ratio	0.90	0.76	Positive
Insiders: Vickers NYSE Sell/buy ratio	3.89	3.65	Negative

BEST-PERFORMING GROUPS

	LAST MONTH %		LAST 12 MONTHS %
Casinos	18.6	Steel	93.6
Internet Software	15.9	Internet Software	87.6
Oil & Gas Drilling	13.8	Oil & Gas Refining	77.3
Oil & Gas Exploration	12.1	Internet Retail	65.5
Computer Stores	12.0	Homebuilding	57.5

WORST-PERFORMING GROUPS

	LAST MONTH %		LAST 12 MONTHS %
Home Entertainment	-8.6	Airlines	-28.1
Food Wholesalers	-7.9	IT Consulting	-25.1
Airlines	-7.4	Semiconductors	-19.1
Soft Drinks	-6.7	Health-Care Distributors	-19.1
Tires & Rubber	-6.4	Semiconductor Equip.	-18.1

EQUITY FUND CATEGORIES

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		LEADERS	
Natural Resources	9.3	Natural Resources	44.8
Latin America	6.9	Latin America	37.7
Precious Metals	6.0	Europe	25.7
Diversified Emerg. Mkts.	4.9	Real Estate	24.2
LAGGARDS		LAGGARDS	
Japan	-5.0	Technology	-1.0
Real Estate	-0.6	Large-cap Growth	6.9
Diversified Pacific/Asia	-0.6	Small-cap Growth	8.6
Financial	0.1	Japan	8.8

EQUITY FUNDS

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		LEADERS	
Winslow Green Growth	14.4	ProFunds Energy U.S. Inv.	69.3
ProFunds Energy U.S. Inv.	14.0	State St. Rsch. Gl. Rs. B	65.6
Oppenheimer Real Asst. A	12.4	ProFds. Wrld. Ultsr. Inv.	61.0
Fidelity Select Nat. Gas	11.8	ICON Energy	59.1
LAGGARDS		LAGGARDS	
ProFds. U.S. Sm. Cap Inv.	-6.9	GMO Asia III	-37.3
Fidelity Advisor Japan C	-6.7	ProFds. Smicdr. Ultsr. Inv.	-32.0
Rydex Large Cap Japan	-6.6	Ameritor Investment	-31.4
Fidelity Japan Small Co.	-6.5	Thurlo Growth	-26.0

INTEREST RATES

KEY RATES

	SEPT. 29	WEEK AGO	YEAR AGO
Money Market Funds	1.19%	1.14%	0.62
90-Day Treasury Bills	1.71	1.71	0.94
2-Year Treasury Notes	2.59	2.47	1.44
10-Year Treasury Notes	4.09	3.99	3.93
30-Year Treasury Bonds	4.86	4.77	4.89
30-Year Fixed Mortgage†	5.71	5.47	5.74

†BancQuote Inc.

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Taxable equivalent yields on AAA-rated, tax-exempt municipal bonds, assuming a 30% federal tax rate.

	10-YR. BOND	30-YR. BOND
General Obligations	3.46%	4.56
Taxable Equivalent	4.94	6.51
Insured Revenue Bonds	3.66	4.80
Taxable Equivalent	5.23	6.86

THE WEEK AHEAD

FACTORY INVENTORIES Monday, Oct. 4, 10 a.m. EDT »

Manufacturing inventories are forecast to have risen 0.4% in August, following a 0.8% jump during July.

NONMANUFACTURERS' INDEX

Tuesday, Oct. 5 10 a.m. EDT »

The Institute for Supply Management's September nonmanufacturing activity index is forecast to have strengthened, to 59%. This is according to the median

forecast of economists surveyed by Action Economics. In August, the index dropped to 58.2%.

INSTALLMENT CREDIT Thursday, Oct. 7, 3 p.m. EDT »

During August, consumers most likely added \$7 billion in debt, after a July gain of \$10.9 billion. Most of the increase in credit this year has been in the form of nonrevolving debt, comprised largely of auto loans. Revolving debt, consisting mostly of credit-card balances,

increased in July, but for only the second time this year.

EMPLOYMENT Friday, Oct. 8, 8:30 a.m. EDT »

Nonfarm payrolls likely rose by 170,000 positions in September, after a modest gain of 144,000 over August. Factory payrolls probably added 11,000 jobs, after an increase of 22,000 in the prior period. The jobless rate is forecast to have held at 5.4%, and average hourly earnings probably grew by 0.2%.

The BusinessWeek production index increased to 228.6 for the week ended Sept. 18, a 13.6% gain from year ago. Before calculation of the four-week moving average, the index improved to 228.6.

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For the BW50, more investment data, and the components of the production index visit www.businessweek.com/magazine/extra.h

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The Canon Way of Growth Innovation Is The Name of The Game

In 1995, when Fujio Mitarai took over as president and CEO of Canon Inc., the future of this global group known for state-of-the-art high-tech cameras and business machines looked uncertain. Having borrowed heavily in an attempt to fund sales growth, it was ridden with debts totaling ¥840 billion (approximately \$7.78 billion).

Today, nearly a decade later, Mitarai is upbeat. Canon has transformed itself into one of the most profitable companies in deflation-hit Japan and will have yet another successful year in 2004. Its consolidated net income is expected to achieve a fifth straight year of record growth – to an estimated ¥320 billion (\$2.96 billion) on sales of some ¥3,470 billion (\$32.13 billion), representing a year-on-year increase of 16.1%. Net income last year was ¥275.7 billion (\$2.55 billion), a hefty increase of 44.6% over the previous year.

With Mitarai at the helm, Canon has also reduced its debts by nearly 90% – to just ¥98 billion (\$907 million) – while building up a cash reserve of some ¥690 billion (\$6.39 billion), making itself virtually debtless. Meanwhile, the company's corporate value has grown dramatically, its market capitalization tripling to ¥4,398 billion (\$40.72 billion) in nine years.

Signaling that success, Canon was ranked No.35 among the world's top 100 brands by *BusinessWeek* magazine this year. In Japan, it was ranked No.1 on a list of the 100 most respected Japanese companies in the first CSR (Corporate Social Responsibility)-based survey conducted by the authoritative *Nikkei Business* magazine earlier this year.

How did Mitarai achieve all this, and much more, in such a short span of time?

Metamorphosis through innovation

"Metamorphosis is in Canon's DNA," says Mitarai with a smile as he explains how the tide has turned. "The key element is our commitment to innovation, which has always been our heritage. Since when we were a small but strong manufacturer and exporter of high-quality cameras right after World War II, we have always built on and expanded



the scope of our innovative technologies to manufacture new products and create new businesses to meet the needs of the changing times.

"When I took over, I was convinced we could bounce back and grow further if I could quickly and clearly convey my vision to my people." His inspiring message: "Let's maximize the use of Canon's technologies, improve them, and profit from them. Any corporation that fails to make profits has no future, and, therefore, no reason to exist."

Mitarai took office after helping New York-based Canon U.S.A. grow from a 13-man operation to a 6,000-strong company during his 23 years in the United States, followed by a six-year period as a director and vice president at Canon's Tokyo headquarters. Mitarai recalls he had become increasingly

alarmed by what he was seeing from across the Pacific as a serious flaw affecting Canon's parent company, at the group as a whole, and admits he was doubly shocked by the seriousness of the situation when he became CEO.

What was the problem? "First and foremost, there was too much complexity across the board at the headquarters, because a 'unifying force' was clearly missing. We had become too busy with our various business divisions and subsidiaries enjoying full autonomy, operating independently, without regard for the overall financial picture of the group."

At the root of the problem, Mitarai cites the Japanese taxation system at the time, which called for accounting on an individual-company basis, drawing attention away from a consolidated

Mingling American and Japanese values, Fujio Mitarai, Canon's dynamic CEO has transformed the global group of high-tech companies into one of the world's most admired – and one of Japan's most profitable – in less than a decade.

accounting-based approach. He immediately decided to introduce across the entire Canon group a business-evaluation system based on consolidated accounting.

"We began seeing positive results right away," Mitarai recalls. "For the first time, I saw our division heads make rounds of sales companies – not just in Japan, but around the world – aggressively helping them market our products. They became genuinely concerned about their divisions' finances, realizing fully that the balance sheet of the whole group would be affected. This really made a great difference."

Getting the message across

Mitarai says being a CEO is a demanding job that requires physical stamina as well as the persuasiveness of an orator. To change the basic thinking of an entire company, you must develop aolute management policy and drive the same message time and again. Educate and enlighten your people. And in my case, I did my best to get my message across directly, persistently, and tirelessly, to as many people as possible."

Mitarai spent countless hours traveling throughout Japan to visit group companies – speaking to top management and plant managers, joining meetings and holding individual sessions expounding the company's financial status and the need for bold cost-saving measures.

To cut the massive production costs that were holding Canon back, Mitarai shut down seven money-losing business operations, including personal computers. He moved quickly to eliminate conveyor belts from the manufacturing process, switching to a new production system called "cell production" and making many tools and key components as possible in-house. Cell-production requires only a small number of workers – sometimes just one – operating in units called "cells" to put together a whole product much more efficiently and quickly than on a conveyor-belt production line. These measures brought enormous dividends.

Although shutting down money-losing operations reduced Canon's yearly sales by ¥73 billion (\$676 million), the company managed to avoid between ¥26 and ¥27 billion (about \$245 million) in lost profit. Also, the shift to cell production saved nearly 8.6-million square feet of space that was previously occupied by conveyor-belt production lines. The removal of some 12 miles of these belts freed up space that is now used for storage, reducing the company's warehouses from 37 to just nine to create further savings of some ¥3 billion (\$28 million) in rental costs.

How to reduce domestic production costs

Mitarai has also managed to reduce production costs by introducing 3-D CAD (three dimensional computer-aided design), which has significantly shortened development times and improved design quality.

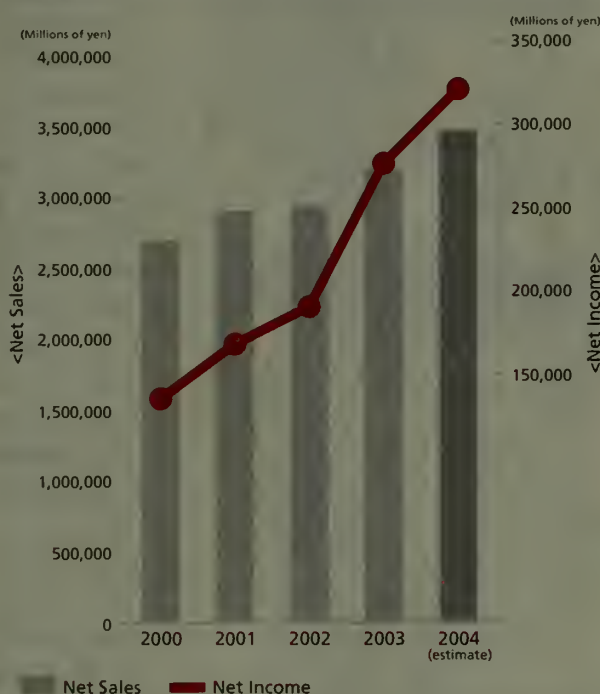
"Defective products, wasteful and expensive, result mainly from flaws in design," says Mitarai. "3-D CAD is also helping us move toward prototype-less production. Development speeds have increased tremendously; products that had taken us 18 months to develop in the past, we can now complete in just 12 months."

"As a result of these measures, we have greatly improved our financial standing," Mitarai points out. "We've reduced our overall manufacturing cost ratio to just below 50%, our debt ratio dropped to 1.6% in the first half of 2004, and we've already reached our equity ratio target of 60%."

"With our initial financial objectives attained, I believe we have paved the way for future expansion. Specifically, we will further strengthen our devel-

opment capabilities, refine our base technologies, and boost our research strength. We will also bolster our production technology capabilities, focusing our efforts on the areas of automated production and the in-house production of key components and devices."

■ Canon's Five-Year Net Sales & Net Income Growth (2000-2004)



Canon has come a long way, but Mitarai says his firm has accomplished barely "60 to 70%" of the goals he has set. "My aim is to make Canon an equal to those quintessential global corporations I have come to know and admire in the U.S. We still have a long way to go to become a truly excellent global corporation, but we are getting there, slowly but surely, fueled by our heritage of innovative spirit."

(*U.S. dollar amounts in this article are translated from yen at the rate of JPY108=U.S. \$1, the approximate exchange rate on the Tokyo Foreign Exchange Market as of June 30, 2004, solely for the convenience of the reader.)

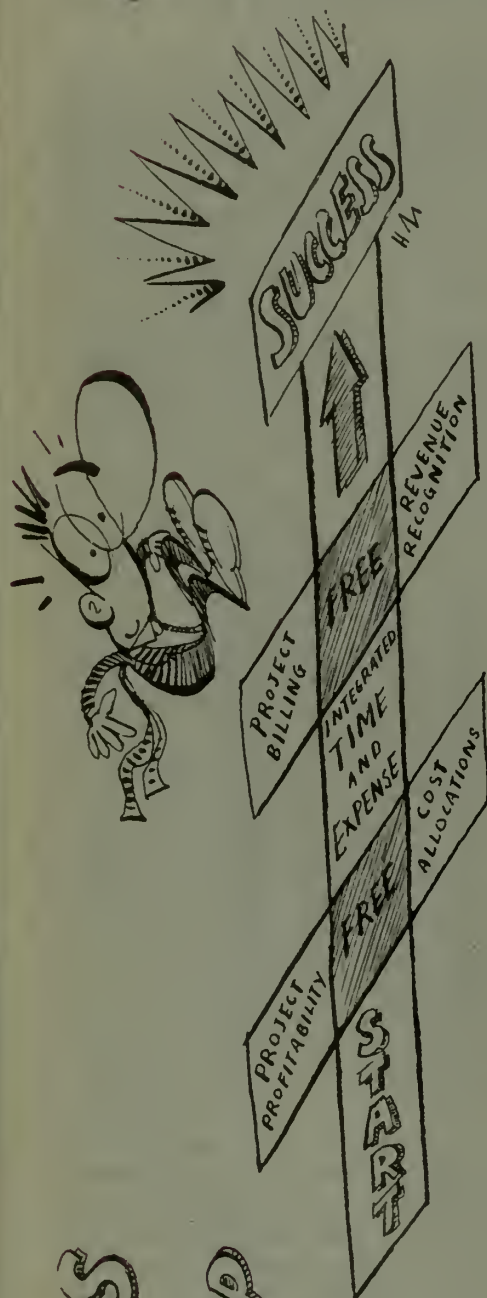
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How to Fire Up The Innovation Machine

THE 75TH ANNIVERSARY issue of *BusinessWeek* is a tribute to the power of innovation. In the years since the magazine was founded in September, 1929, technological and scientific breakthroughs have given us jet travel, antibiotics, computers, high-yield crops, television, space exploration, the Internet, genomics, cell phones, and a host of other advances. Yet innovation remains an enigma. As Asia begins to join the U.S. and Europe in building high-tech, high-growth economies, the search to unlock the secrets of innovation is quickening. Fortunately, we have learned valuable lessons in recent years in how to nurture the ecology of innovation. Here are some of them:

INNOVATION CAN BE TAUGHT. It is not culturally determined. There was a time, not long ago, when the conventional wisdom decreed that "Confucian cultures cannot innovate." They were said to be too hierarchical—with education being by rote learning. Only Western cultures, especially the U.S. and Europe, were said to be able to create the new.

Yet today, Korea is a leader in digital displays, electronic gaming, and wireless telecom. China produces advanced computer graphics and synthetic-language software. Indeed, innovation is sprouting across Asia as colleges and universities expand and as curriculums are transformed. India is building a cadre of highly trained engineers and programmers from the Indian Institute of Technology. Japan is renewing its commitment to cutting-edge products in nanotech, auto engine technology, and electronics. In short, Asians are discovering that they are not prisoners of their past.

INNOVATION CAN BE MANAGED. Corporations have long been stymied by innovation's elusive nature. Only a fraction of all innovation ultimately pays off. But new research in improving the "rate" of innovation is letting corporations choose the right strategies to boost their chances of success. And it's not just high-tech companies that are succeeding. Staid consumer-products giant Procter & Gamble and Korean electronics producer Samsung Group have remade themselves by combining their technological strengths in chemicals and electronics with new ethnographic and behavior practices from anthropology and psychology to bring them closer to the needs and wants of their customers.

P&G, Samsung, and others like them put great energy into learning what their customers crave—and into designing their innovation process to satisfy them. So close are they to their customers that they are beginning to co-create with them. In what is fast becoming an era of ubiquitous invention, low-cost production, and international distribution, success increasingly goes to those companies who focus on creating better things with their customers, not for them.

INNOVATION CAN BE SPURRED. Risk-taking speeds up the pace of innovation. The glorious sight of the private, manned SpaceShipOne rocketing to the edge of space is a testament to the role of private capital in innovation. Financed largely by Microsoft billionaire Paul Allen, SpaceShipOne is a completely original vehicle for getting people into space—at a fraction of the shuttle's cost. Virgin Group's Richard Branson is licensing SpaceShipOne's design to take tourists to space by 2008.

Nations around the world are trying to learn the lesson of American financial risk-taking. Innovation generates options on future products and services. Successful innovation

Financial risk-taking is the fuel that powers the process of change

requires a well-developed capital market that allows people to invest in these possibilities to see if they are The Next Big Thing. No country beats the U.S. at this—yet. Its huge venture-capital industry has billions to fund new companies. Its IPO market allows first-round winners to scale up by going public. Its huge stock market has enough depth to spread the risk of new ventures. And its low taxes on capital gains reward

people for taking that risk. Ebay, Amazon, Genentech, and Google were all born out of risk-taking.

Continental Europe has traditionally struggled with encouraging and rewarding risk. Despite Europe's incredible record with invention, its ability to finance new companies has been weak. Europe is trying to do better and Asia must as well. There is a strong tradition of entrepreneurialism in Asia. It needs risk-taking finance to take innovation and make it an engine of growth.

At a time of intense division, with deep political and religious fault lines splitting the world, innovation stands out as a powerful integrative force. It ties countries, companies, and consumers together in creating value, solving problems, and generating wealth. An innovation economy demands that society be open, dynamic, educated, international, and risk-taking. Given a chance, innovation can improve all our lives.

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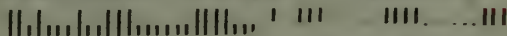
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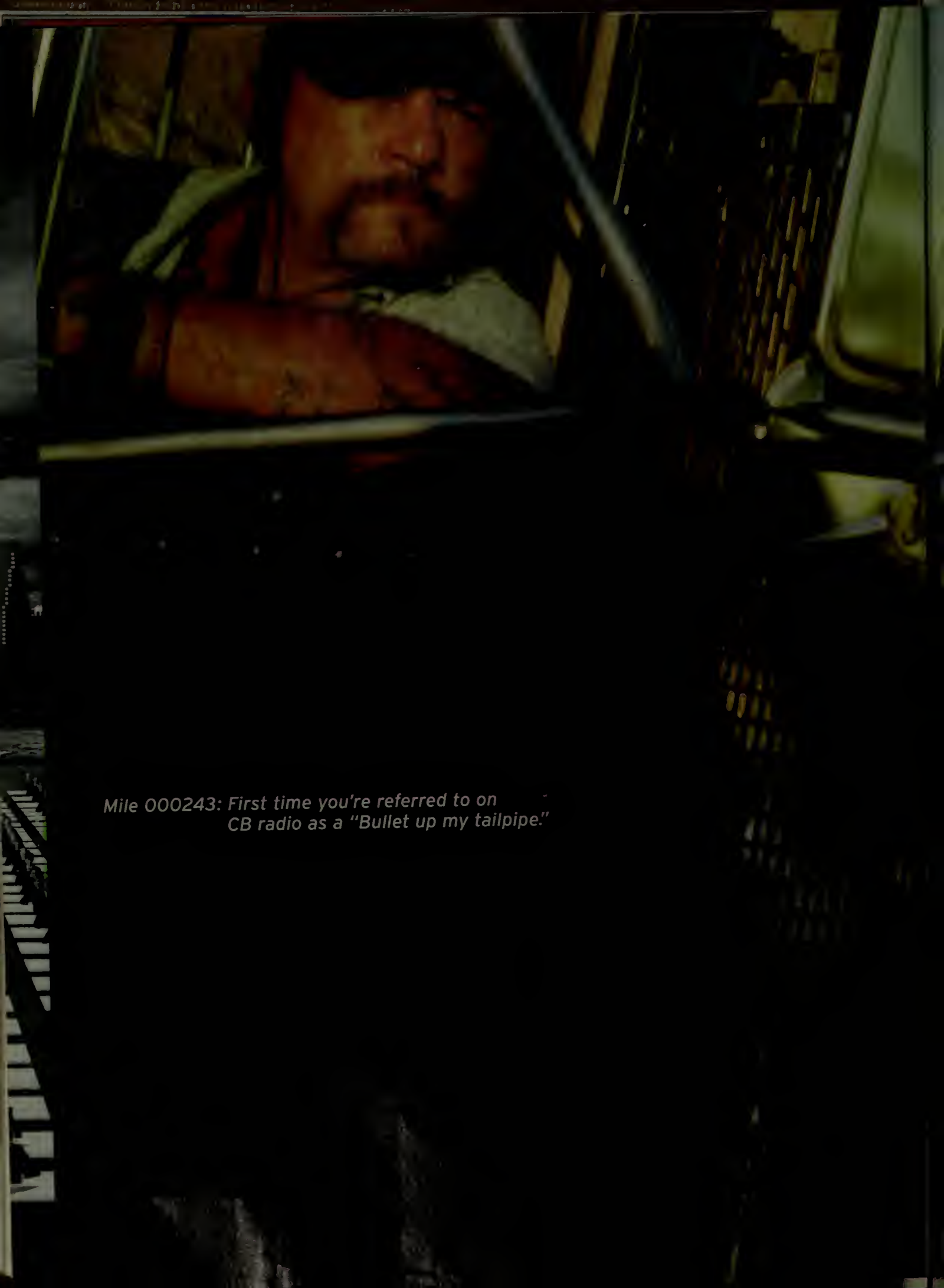


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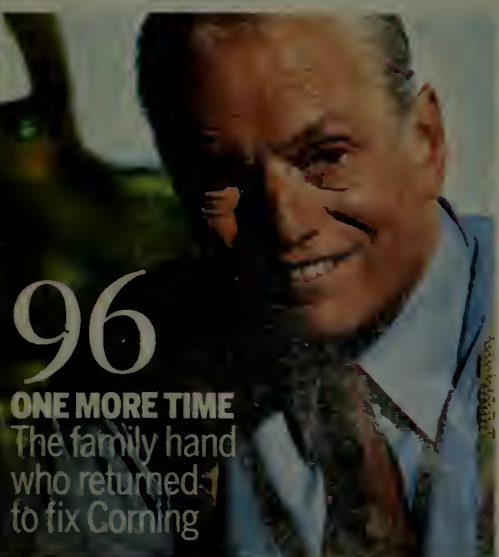
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Bush or Kerry: Who Will Be The Innovation President?

Nurturing America's inventive spirit is vital to its long-term well-being, but this crucial subject won't get much attention in the remaining debates. So here's a policy scorecard on the candidates



Caterpillar: The View from the Cab

Last February the heavy-equipment maker's CEO James Owens predicted increased overseas demand would push 2004 profits up by 40%. In a Q&A he admits he was way off—profits should jump 80%. And 2005 looks even better

Will TiVo and Netflix Make a Picture-Perfect Pairing?

When they finally announced their long-rumored video-on-demand deal investors applauded, but issues of content, copyright, and competition make a happy ending less than certain



Capgemini Could Be Up for Grabs

With the global economy improving, analysts are betting on consolidation in Europe's tech-services sector. Given the recent drop in its stock and what looks like solid prospects for a comeback, the Paris-based outfit seems a likely takeover target

How Renault Jump-Started The Nissan Revival

Louis Schweitzer, the French carmaker's CEO, speaks out on the turnaround's key elements: "Linchpin" Carlos Ghosn, trust, and a performance focus



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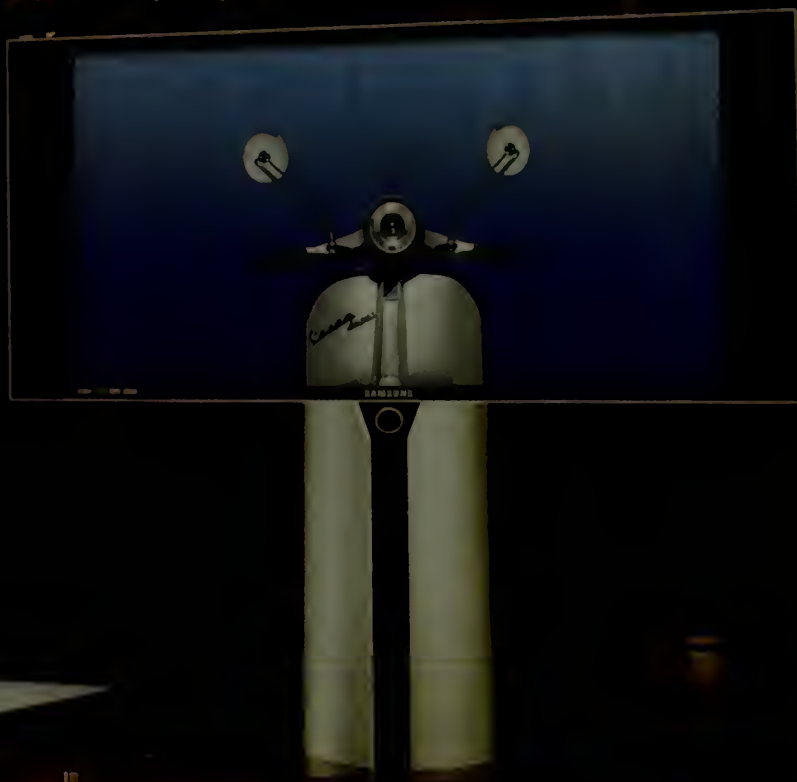
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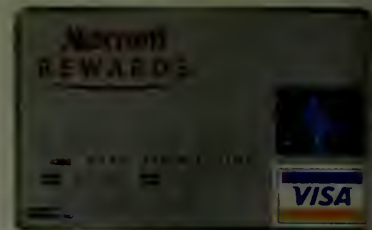
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JP Front

"I'll bet both [Bush and Kerry] were wishing they could reach as many people on a daily basis as I do."

—Oprah Winfrey, dismissing a possible future in politics, in *New York's Daily News*

EDITED BY IRA SAGER

AFTERLIVES HERE'S LIFE AFTER SCHWAB

THREE MONTHS AFTER being ousted from **Charles Schwab**, David Pottruck is teaching at a business school and getting into the private equity business. The former Schwab CEO has formed **The Pottruck Group** to invest his own money, *BusinessWeek* has learned.

So far, the "group" is just Pottruck and an assistant—sharing an office in San Francisco with private equity

Pottruck is evaluating companies. "Maybe in the process of looking at companies, I could find one where I could actually end up as the CEO," he says.

On Oct. 12, Pottruck will start teaching a five-week course for senior managers at the **Wharton School**. An alum, Pottruck joined as a senior fellow in the management department before the fall semester began. His course will be "The Role of the CEO," covering "lessons learned."

The 56-year-old Pottruck is upbeat about his 20 years at Schwab, although his final 14 months were tough—

especially working in the shadow of the founder and chairman, Chuck Schwab. "I never considered Chuck Schwab and myself to be equal," he says. Even after Schwab handed off the CEO job in May, 2003, there was always a lingering possibility that he might want it back. Schwab took the post after Pottruck left.

Pottruck accepts the blame for Schwab's poor performance on his watch. He concedes

that opportunities were missed, including the boom in mortgage refinancing, 401(k) plans, and bank consolidation. But he does expect to return to the executive suite at some point, although no offers have come in yet. Luckily for him, second acts in business are not uncommon. Chuck Schwab was once a failed mutual-fund manager.

—Justin Hibbard

EISNER AND OVITZ
Before the bust-up



DISNEY SLUGFESTS

The Ovitz Affair: Directors Beware

THE HOTTEST STORY LINE at **Walt Disney** is nearly 10 years old and plays out in a Delaware court on Oct. 18. That's when Disney board members go on trial, in a shareholder lawsuit, for allegedly failing to oversee properly CEO Michael Eisner's 1995 hiring of talent agent Michael Ovitz as president. At issue: Will board members have to repay the estimated \$140 million Ovitz got when he was forced out after just 15 months?

The case—a "derivative lawsuit," in which damages would be paid to the company, not the shareholders—is already a soap opera, with tales of backbiting by anti-Ovitz Disneyites and of Ovitz' wild spending. In allowing it to proceed, Judge William Chandler noted that board minutes show little time was spent approving Ovitz' contract and no questions were asked. Chandler questioned whether directors could "be held personally liable to the corporation for a knowing or intentional lack of due care."

If found to have acted in "bad faith," directors could be forced to pay damages unless their insurance specifically covers it, says Charles Elson, a **University of Delaware** professor. Disney wouldn't discuss directors' insurance, and directors' lawyers declined comment.

—Ronald Grover



San Francisco
Partners.

Pottruck says
he's eyeing

several fields, including companies that provide outsourcing services, pay-for-performance advertising that's popular on the Net, and health care for baby boomers. Together with co-investors, he plans to take majority stakes in established companies or spin-offs from public companies. No investments have been made, though

POTTRUCK Teaches
at Wharton and
steers investments

STOCK ANSWERS AN INDEX FOR BOARD WATCHERS

RESEARCHERS HAVE long tried to assess the impact of good governance on stock returns. On Nov. 1, proxy adviser **Glass**



Lewis will introduce a stock index that links the two. Based on research from **Harvard Law School** professor Lucian Bebchuk, the Shareholder Rights Index reweights the **Standard & Poor's 500-stock** index, giving more heft to companies with less-entrenched boards.

Bebchuk's innovation is to home in on six provisions that hurt shareholder value. Black marks are given to companies with: staggered boards, which protect against proxy fights; limits to amend by-laws; supermajority requirements for mergers; limits to amend the company charter; poison pills; and golden parachutes.

The lower the occurrence of any of these, the more weight a company receives in the index. **Southern Co.**, **First Data**, and **CVS**, for instance, have a much larger position in the Shareholder Rights Index than they do in the S&P 500, according to Greg Taxin, CEO of Glass Lewis.

Taxin has confidence in Bebchuk's research, which has shown that the absence

of those six "bad guys," as Bebchuk says, correlates with increased shareholder value. From 1990 to 2003, Bebchuk says, an investor holding stocks with none of the six bad indicators, while shorting stocks with five or six of them, got an annual 7% premium on his returns.

Bebchuk cautions that past results don't always reflect future returns. But he thinks the research may be a guidepost to make institutional investors more effective watchdogs. "It's a better identification of what provisions institutions should target, other than going after

provisions that are innocuous," Bebchuk says. And for companies, it's a measure of how to do good, and do well. —Brian Hinde

SOUTHERN CO. Kudos for good governance

SOME LIKE IT HOT
Marilyn Monroe
at the Cocoanut
Grove nightclub



INN BUSINESS

FAREWELL HOTEL It hosted six Academy Awards. Its Cocoanut Grove nightclub helped launch singers like Bing Crosby. Nixon wrote his "Checkers" speech by the pool. And in 1968, Robert F. Kennedy was shot in its pantry. **Los Angeles' Ambassador Hotel** may soon face its own demise. On Oct. 12, a school board, which owns the long-shuttered hotel, will vote on a proposal to tear it down for an elementary school. A facade like the original would be built, but critics want the hotel intact. School officials say that would add \$100 million to a \$318 million project. But it would be a good history lesson. —Christopher Palmieri

DRAWN & QUARTERED



"I'm afraid your M.B.A. loses some of its lustre in light of the fact that you were home-schooled."

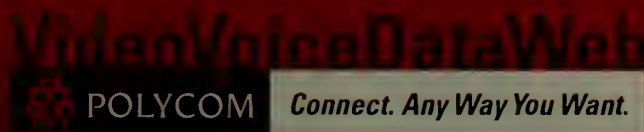
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FACE TIME

LAWRENCE AURIANA



FIGHTING THE MOB LABEL-AGAIN

The evil great whites in the animated movie *Shark Tale* have Italian names and the voices of actors known for mobster roles, including Robert De Niro (*The Godfather II*) and Michael Imperioli (*The Sopranos*). That has Lawrence Auriana mad enough to bite off someone's leg. "It's a horrendous exhibition of negative stereotypes," says Auriana, co-manager of the \$6.5 billion Federated Kaufmann Fund and president of the Columbus Citizens Foundation, an Italian-American heritage group.

Auriana sent a letter to Steven Spielberg, a founder of the film's producer, DreamWorks SKG, asking that Italian names, mannerisms, and speech be removed—to no avail. So at the New York premiere on Sept. 27, attendees faced a phalanx of leafleteers—also to no avail. *Shark Tale* took in \$49.1 million at the box office over the weekend.

Two years ago, Auriana did get a court to block actors from *The Sopranos* from joining his group's Columbus Day Parade. —Lauren Young

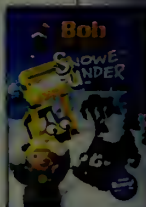
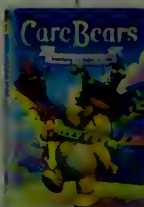
MAD AVENUE

WILL YOUR KIDS' FAVORITE DVD BE AN AD?

THINK THERE'S too much product placement in TV and movies, especially aimed at kids? Well, this fall, brand names won't just be sprinkled into show—they'll be the show. More toymakers are going Hollywood with their own direct-to-video animated full-length feature films.

Mattel's Barbie is the queen of the genre, having turned out three films in as many years, each grossing about \$35 million, plus more than \$200 million in sales of related items for each film. But Barbie isn't the only toy that's ready for a closeup. Hasbro's G.I. Joe, LEGO's Bionicle, American Greetings' Care Bears, and Hit Entertainment's Bob the Builder will all have feature films out this fall.

Toymakers see feature films as the next step from TV and



COMING TO YOUR LIVING ROOM One long commercial

short-story video—and critical to establishing fresh stories and characters on which to base new toys. Besides, as a media buy, it's hard to beat your own feature film for kids. Children,

especially preschoolers, watch their favorite DVDs more than 100 times. Talk about media saturation. —David K

For an extended version, go to www.businessweek.com/magazine/extra.htm



CAR TALK: ON TRACK TO GRAB MORE TRUCK BUYERS

TOYOTA MOTOR HAS a novel way to reach truck buyers scattered throughout the country: moving billboards. The company struck a deal with Amtrak to paint the lead car of cross-country trains

HITCHING A RIDE Toyota via Amtrak

with an ad for its Tundra Double Cab. The one-month campaign, which kicks off on

Nov. 1, covers trains on two popular routes: the Silver Service, from New York to Florida, and the Texas Eagle, from Chicago to Los Angeles. It's part of Toyota's drive to boost its share of the booming U.S. truck market. The company won't say how much it's spending, but Amtrak says it charges about \$10,000 a month per train, not including the paint job.

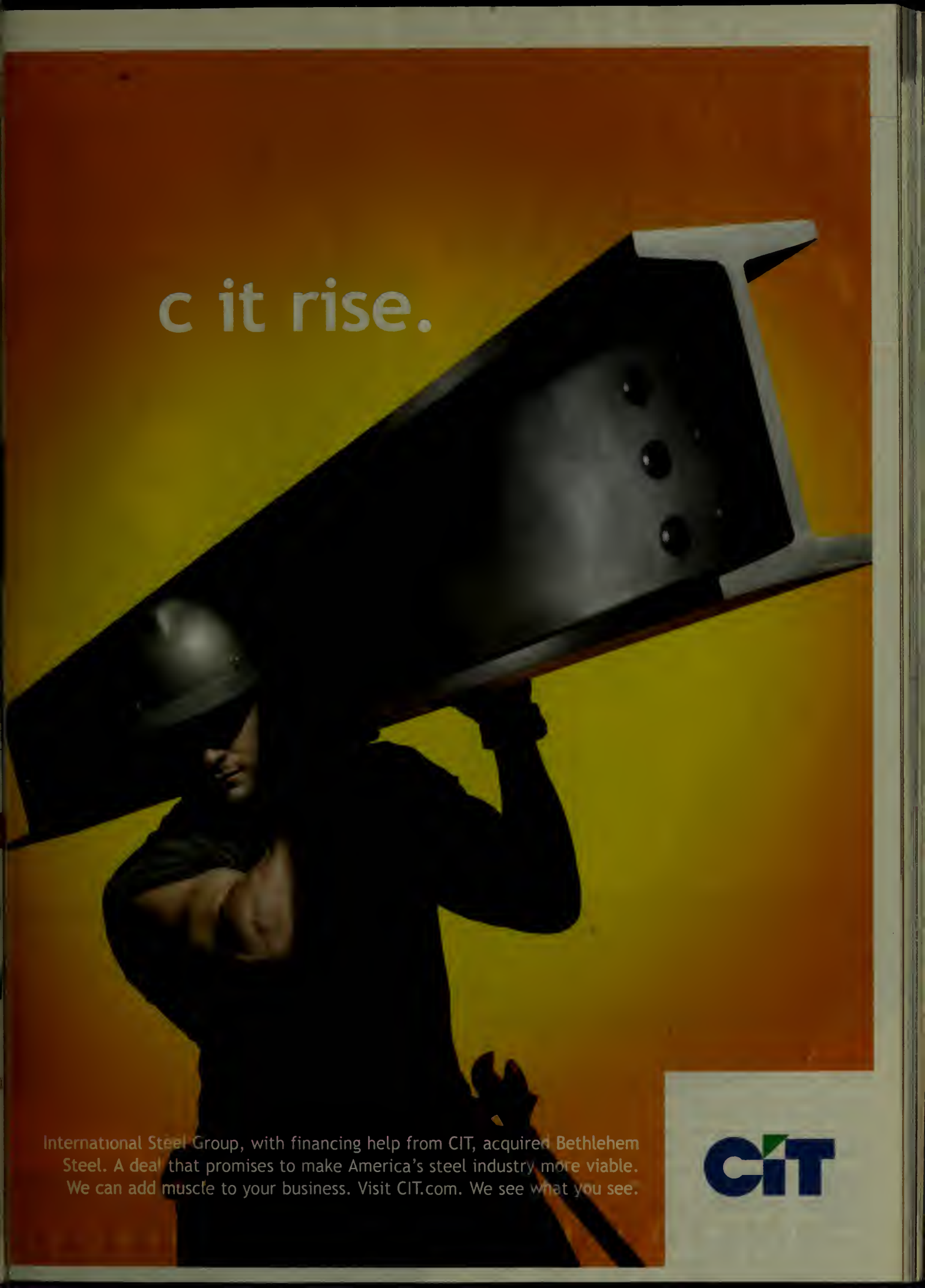
—Chester Dawson

THE STAT

12

The percentage of Americans who would support a tax on Net access—including 11% of Bush backers and 13% of Kerry supporters.

Data: ccAdvertising poll. Commissioned by CapNet. of 26,383 adults in swing states. Sept. 27, 2004.



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The World of Golf



The Ryder Cup: Teams of the Future

Even if the American team had lived up to its billing and won this year's Ryder Cup, it is probable that the team that contests the 2006 competition at the K Club in Ireland will be very different to the 12 who lined up at Oakland Hills in 2004. At 28, Tiger Woods was the youngest member of the team and the only American contestant in his twenties, although Chad Campbell and Chris Riley are both 30 and Stewart Cink is 31. Nevertheless, the inclusion in the American team of more senior stagers such as Jay Haas (50) and Fred Funk (48) pushed its average age up to 36.75.

That contrasted with an average age of the European team of a little over 32; and although it was a 41-year old in the shape of Colin Montgomerie who sank the winning putt, the individual who turned the tide irreversibly in Europe's favor on the final afternoon was the youngest player on the golf course. At 24, Spain's Sergio Garcia was playing in his third Ryder Cup, and his impact this year was as decisive as it was five years ago. In 1999, as the youngest-ever competitor in the Cup's history, Garcia partnered with Jesper Parnevik to beat the formidable pair of Tiger Woods and Tom Lehman. In 2004, Garcia countered America's fight-back in the singles with an emphatic win over this year's US Masters Champion, Phil Mickelson.

Prior to Garcia's heroics it had been the European rookies, Paul Casey (27) and David Howell (29), who had provided the key turning-point of the second day. With Woods, Riley, Cink and Davis Love III spearheading a powerful American revival in the four-balls, the young Europeans turned a one-hole deficit against Jim Furyk and Chad Campbell on the seventeenth tee into a victory on the eighteenth green.

The youthful backbone of the European team is set to remain in place until 2006 and beyond.

While Europe's elder statesmen, Colin Montgomerie (41) and Miguel Angel Jimenez (40), will probably need to rely on wild cards if they are to participate in future Ryder Cups, the youthful backbone of the European team is set to remain in place until 2006 and beyond. After his triumphant performance in 2004, meanwhile, Bernhard Langer may also retain his captaincy for the next Ryder Cup. With the two Irish heroes of Oakland Hills, Padraig Harrington and Paul McGinley, both near-certainties to play in 2006, there are no obvious local candidates to captain the European team in Ireland. In 2010, when the competition comes to Wales for the first time, the Welshman Ian Woosnam who vice-captained the European team in the 1999 Ryder Cup would appear to be a natural choice.

With a number of very highly-rated young players emerging on the US PGA TOUR, Europe should not assume that its record-breaking win in 2004 is an automatic prelude to a period of Ryder Cup dominance.

2004

2006

The outlook for the US captaincy is less clear. With Hal Sutton's brave decision to pair Tiger Woods and Phil Mickelson together during the opening round of this year's four-balls having backfired so woefully, it is probable that there will be a new captain, as well as a number of new players, representing America in Ireland in 2006. Although the crop of newcomers may not be able to match their European counterparts for experience, with a number of very highly-rated young players emerging on the US PGA TOUR, Europe should not assume that its record-breaking win in 2004 is an automatic prelude to a period of Ryder Cup dominance.



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The Great Innovators

CELEBRATING

75

As part of its anniversary celebration, BusinessWeek is presenting a series of weekly profiles of the greatest innovators of the past 75 years. Some made their mark in science or technology; others in management, finance, marketing, or government. For profiles of all the innovators we've published so far, and more, go to www.businessweek.com/innovators/

Giving Birth To Biotech

IN 1976, Robert Swanson and Herbert Boyer created the biotechnology industry over a couple of beers at a San Francisco bar called Churchill's. Swanson, at just 29, was an ambitious venture capitalist who wanted to commercialize a new way of engineering drugs based on splicing DNA from one organism into the genome of

another. Boyer, a 40-year-old biochemistry and biophysics professor at the University of California at San Francisco, had co-developed an ingenious technique for doing exactly that. So Swanson cold-called Boyer, stopped by his lab, and the two retreated to the bar to sketch out a business plan. They were about to change the drug industry forever.

The discovery at the crux of their plan was called recombinant DNA. The idea had been around since the early '70s, and many scientists were laboring to commercialize it. But Boyer was the first to perfect a technique for snipping out DNA—the blueprint molecules that cells use to make proteins—and combining it with fragments of DNA from another organism. Teaming up with Stanford professor Stanley Cohen, Boyer pioneered a method of inserting segments of the recombined DNA into *E. coli* bacteria. The microbes, in effect, became tiny factories, churning out drug proteins encoded by the new DNA. To turn the invention into a business, Boyer and Swanson incorporated under the name Genentech Inc. In 1982, the company and its marketing partner, Eli Lilly & Co., won Food & Drug Administration approval for the first genetically engineered drug, human insulin. Soon other biotechnology companies sprouted, using recombinant DNA to produce drugs aimed at everything from anemia to cancer.

Swanson and Boyer bonded over a mutual love of science. Growing up in Derry, Pa., the athletic Boyer was pulled into the field by his high school's football and basketball coach, who was also the school's science teacher. As an undergraduate at

A venture capitalist and a scientist changed how drugs are made

St. Vincent College, he was captivated by James Watson and Francis Crick's groundbreaking 1953 revelation that DNA was a double helix. "The whole structure was so beautiful, and it explained so much about genetics," says Boyer, who is now retired and living near San Diego. "It put me on my career path." Swanson, who was born in Brooklyn, N.Y., studied chemistry and management at Massachusetts Institute of Technology. He started his career as a venture capitalist at Citicorp Venture Capital Inc., then moved to Kleiner & Perkins, the firm that later provided \$100,000 in seed capital for Genentech.

The scientist and the businessman played off each other perfectly. As CEO, Swanson preached the benefits of biotech to potential investors while Boyer watched out for the scientists on the staff. It was Boyer who persuaded Swanson to let the whiz kids publish their research, even at the risk of exposing Genentech's trade secrets.

Swanson died of brain cancer in 1999 at the age of 52, just three years after retiring as chairman of Genentech's board. Boyer retired as vice-president in 1991 and has remained on the board of directors ever since. The biotech industry now encompasses more than 1,400 companies in the U.S. alone and generates \$39.2 billion in annual revenues. Boyer says he and Swanson couldn't fathom the impact their invention would have on the world. "When he walked into my office, it changed my life," Boyer says. And the lives of millions of patients and their families. ■

—By Arlene Weintraub



SWANSON AND BOYER

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Back to B-School

TO THE RELIEF OF THOUSANDS OF NEWLY minted MBAs, the Class of 2004 graduated into a vastly improved job market compared with their 2002 counterparts. Graduates surveyed for *BusinessWeek's* previous Best B-Schools rankings (Oct. 21, 2002) faced massive layoffs, and a wave of corporate scandal

that was leading many to question the value of the MBA degree. Now, recruiters are back. Starting compensation is up 26%. And students are demanding more rigor from MBA programs as well as more courses in ethics and leadership.

BusinessWeek's ninth biennial ranking of the Top 30 B-schools, led by Jennifer Merritt, has many new features: A graphic depiction of student responses stacks up the Top 30 schools, side by side. We've expanded coverage of international schools, including a feature on Europe's go-getters.

Meanwhile, *BusinessWeek* Online's B-schools channel (businessweek.com/bschools) has additional stories, forums, our B-school calendar, plus full details on more than 250 full-time MBA programs. MBA Insider, our premium site, has a wealth of features and tools for MBA prospects.

BusinessWeek was the first publication to rank business schools, starting in 1988. Today, we have several imitators, but none comes close to the consistency



ON THE TEAM Kate Hazelwood, Jessica Sanders, Jennifer Merritt, Frederick F. Jespersen, Louis Lavelle, Steven Taylor, Ronnie Weil, Vera Naughton, Elizabeth Weiner, Erin Chambers

and quality of our rankings—which are based on “customer satisfaction” surveys of students and the recruiters who hire them.

Happy hunting.

Stephen B. Shepard

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FRIDAY, AUGUST 29, 2003 - VOL. CXXII NO. 43 - *** \$1.00

When it came to our tasting of "white goods," the superpremiums ruled the day. Here, our top three in each category, plus our tasters' comments:

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THE PROPER ROLE OF JUDGES

FIRST, WE SHOULD not be surprised that judges begin to act like politicians when they stop being judges and become de facto legislators ("The battle over the courts," News: Analysis & Commentary, Sept. 27). Today's judiciary makes too many public policy decisions that are appropriately made by legislators. Second, we should not be surprised that certain state judges in certain places are blatantly biased in certain of their actions.

Alexander Hamilton made the following commonsense observation in *The Federalist Papers* (No. 80): "No man ought certainly to be judge in his own cause, or in any cause in respect to which he has the least interest or bias. This principle has no inconsiderable weight in designating the federal courts as the proper tribunals for the determination of controversies between different states and their citizens. And it ought to have the same operation in regard to some cases between the citizens of the same state."

Many problems you outlined would be much less serious if judges just judged and if significant class action litigation were adjudicated in federal courts.

-Howard Landis
Naples, Fla.

AS A RESIDENT of one of the 12 states with a nonelected judiciary, I would be glad to have the "problem" of the hotly contested elections you describe. You imply that appointing judges somehow eliminates their partisan biases. As we have learned most recently in Massachusetts with the gay marriage issue, it doesn't. It merely immunizes them against public scrutiny and removal from office.

The 19th century populist and progressive reformers made direct election of state judges a centerpiece of their efforts to make government accountable to the people. They knew an unelected judiciary is a dagger aimed at the heart of democracy. Far better to know the views of those empowered to rule on key social and political issues in advance than to have those views imposed on us without recourse.

-John K. Dirlam
Wellesley, Mass.

EVERY CIVICS CLASS should be required to read your Cover Story. It's not "sound-bite" journalism—it encourages readers to consider the very real threat to our system of courts. And, you don't need a lawyer or a teacher to explain it for you.

-Paul Towber
Salinas, Calif.

CORRECTIONS & CLARIFICATIONS

"Falling bond yields: Not to worry" (News: Analysis & Commentary, Oct. 4) stated that FedEx Corp. warned that profits would fall short of expectations. What FedEx did was reaffirm its earnings guidance for its 2005 fiscal year, disappointing Wall Street analysts who had expected more.

"Supercharging Silicon Valley" (The Great Innovators, Oct. 4) misstated the title for Intel Corp.'s Andrew S. Grove. He is stepping down as chairman next year to become chairman emeritus.

The timeline accompanying "Nissan's boss" (News: International Business, Oct. 4) should have said that in 1986 (not 1990), B.F. Goodrich divested its tire and rubber business to Michelin. There was no merger.

"The Muddle in the BCS Huddle" (Sports Biz, Oct. 4) incorrectly stated that the University of Southern California football team went undefeated last year. In fact it lost one game, 34-31, to the University of California at Berkeley—on Sept. 27, 2003.

YOU RAISED IMPORTANT questions, but your article took an unfair swipe at People for the American Way, suggesting that we help "ambush" judicial nominees with "unsavory biographical tails." Our opposition to some—less than 10%—of President George W. Bush's judicial nominees has been grounded in their public records and judicial philosophies. Especially for lifetime appellate court judges, who have the final word in most cases, it is senators' constitutional duty to consider a nominee's approach to the laws and Constitution.

-Ralph G. N.
People for the American Way
Washington, D.C.

SHARPER IMAGE IS HEADING FOR SHARPER REVENUES

WITH SURPRISE, I read "Sharper Image needs... a sharper image" (News: Analysis & Commentary, Sept. 20). We believe that key positive aspects of the company were overlooked, including our sales trend, which has grown from about \$500 million of revenues in 2002, to \$650 million in 2003, to this year's estimated nearly \$800 million, and our impressive earnings, which we estimate will achieve a third consecutive record year.

We are excited about our multi-channel retail business of stores, catalog/direct response, and Internet, and our g

We believe we adhere to stringent governance practices, but we needed an independent opinion. A Standard & Poor's Corporate Governance Evaluation helps us to better understand our strengths and weaknesses. Their objective assessment is a valuable tool that enables us to communicate to our investors and stakeholders the substance of our governance practices. Now, if only it was that easy to get my kids to do their homework.

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growth in wholesale. If all goes as projected, next year we may approach \$1 billion of sales, with record earnings. The retail business is unpredictable, but we are pointed toward a goal that we are really working hard to achieve.

Rather than point out the areas of reporting with which we disagree, let's focus upon the bottom line: The company is doing very well, and the prospects for continuing to do so are very favorable.

—Richard Thalheim
Founder and CEO
Sharper Image
San Francisco

NEEDED: MORE ACCESS TO HEALTH INSURANCE

I SYMPATHIZE WITH small-business owners caught between spiraling health insurance costs and a desire to provide coverage ("Health insurance: Small biz in a bind," News: Analysis & Comment, Sept. 27). But my heart really goes out to the millions of American workers who have lost their health coverage because of this crisis. In Nevada, more than one out of five working adults is uninsured, according to the Robert Wood Johnson Foundation. Most are employed by small businesses that can't afford the double-digit premium increases of the last few years. Their families live in fear of an accident or illness that would ruin them financially.

The high cost of health care is also a drag on job creation. We must act now, not later. I have introduced in the U.S. Senate a tax credit that would offset up to half the cost of health insurance premiums paid by small businesses. This measure would expand health insurance coverage and help businesses create more jobs.

—Senator Harry Reid (D-Nev.)
Searchlight, Nev.

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Change Happens. Act Now

CONFRONTING REALITY Doing What Matters to Get Things Right
By Larry Bossidy and Ram Charan; Crown Business; 264pp; \$27.50

Larry Bossidy and Ram Charan are in tune with the business zeitgeist. Two years ago, the oddly paired duo—Bossidy is the blunt former CEO of Honeywell International Inc., while Charan is a smooth-talking management guru—produced the best-seller *Execution: The Discipline of Getting Things Done*. In an

era of low growth and shattered expectations, that volume's focus on getting results resonated with readers. Now Bossidy and Charan are back with another exhortation, *Confronting Reality: Doing What Matters to Get Things Right*. Coming at a time when Corporate America is being jolted by everything from the expanding reach of Wal-Mart Stores Inc. to business challenges from China, the new book cannily addresses the pressure on managers to train a microscope on their business models.

Confronting Reality is divided into four parts. It begins with a somewhat obvious essay on why managers must overcome wishful thinking and come to grips with the realities that face them. Bossidy and Charan then grab our attention by offering a new model for accomplishing this feat. Next they provide several recent case studies that hold lessons about what to change and what not to change. They conclude with tips on how to prepare an organization for transformation.

Some may wonder whether the new work is merely an attempt to capitalize on the success of *Execution*. It's not. The busy authors have managed to bring fresh insights to a matter that's high on the corporate agenda. What's more, *Confronting Reality* is even more readable than its predecessor.

One reason *Confronting Reality* succeeds is that it truly does confront reality—unlike *Execution*, where hypothetical examples were common. Cases in which a manager was simply referred to as Joe, or a corporation known as XYZ Co., sometimes gave the earlier book the feeling of a business fable. This time there are interesting narratives built around real-world characters and entities. Most get kudos for their courage. EMC Corp. chief Joseph M. Tucci and Cisco Systems Inc.'s John Chambers are portrayed as men who have steered their companies wisely amid unsettling industry shifts. Bossidy's employer of 34 years, General Electric Co., is depicted as a place that spawns smart, driven realists such as, well, Bossidy himself. As in *Execution*, Bossidy offers some folksy musings on his leadership of AlliedSignal and the entity that resulted from its merger with Honeywell—only now the stories focus on the

many times in his career that he was forced to face unpleasant facts. Once again, though, he misses an opportunity to reflect on any mistakes he may have made. There are also profiles of 3M Chief Executive Jim McNerney, Home Depot Inc. CEO Robert L. Nardelli, and Stanley Works' head John Trani—all GE veterans—along with current GE chief Jeffrey Immelt and his iconic former GE boss Jack Welch.

While the book is largely an examination of what it takes to be a winner in a fast-changing world, there are some cases of losers. Kmart Corp.'s leaders, though unnamed, are slapped for failing to adapt to shifting realities, thus letting Wal-Mart gobble their franchise. The authors also join the chorus of critics who say Scott McNealy of Sun Microsystems Inc. has been blind to the need for a new business model. But they add that "given his history of bucking the odds, we can't write off

his chances of recovering." Then there are what the authors call "structurally defective industries"—autos, airlines, commodity chemicals, even professional baseball—that are saddled with excess capacity, high fixed costs, or inept regulatory policies that it's almost impossible to succeed. For many trapped in the purgatory of these industries, reality bites.

The book's most useful part is its model for facing facts in three areas—external realities, internal realities, and financial targets—helping readers to see how these are linked and how to reassess them. Financial aspirations are tested against both external realities—everything from industry trends and the financial health of rivals and internal ones, such as whether the right

people are in the right jobs. The value comes in what Bossidy and Charan call "iterating the model," or constantly applying it and revising it to stay current with the changing business environment and a company's evolving strengths.

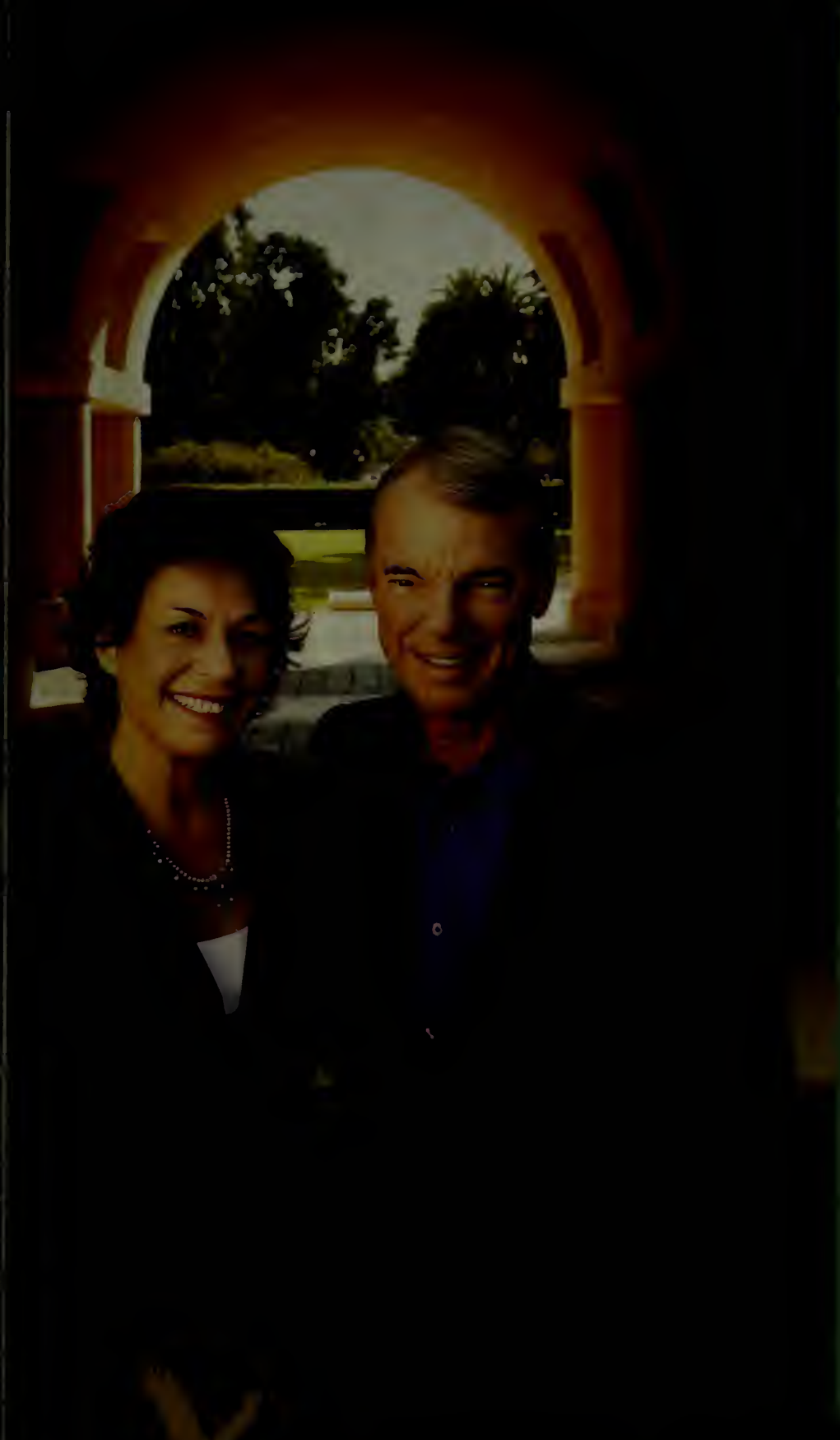
These discussions may strike some readers as pretty basic, but it's clear from the anecdotes that many managers need to go

Execs can use the authors' nifty model to test their strategies

back to step one. In the authors' view, the primary goal is not simply to face facts when designing a business model. It's to design a model that becomes a tool for constantly confronting reality. Used properly, such an approach could help executives kill unrealistic ideas. It may even inspire some to restructure their core operations. In their first book, Bossidy and Charan struck gold by telling readers how to execute strategies. They may be doing them a greater service this time by helping them ensure that the strategies are worth pursuing at all. ■

—By Diane Br





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BY ROBERT KUTTNER

How to Undermine An Ownership Society

President George W. Bush has spoken repeatedly of an Ownership Society. In his acceptance speech at the Republican National Convention in New York, he quite reasonably declared: "Ownership brings security, and dignity, and independence." Specifically, in the ownership society he envisions, "more people will own their health plans and have the

confidence of owning a piece of their retirement."

Reflect on this for a moment. It's one thing to own your own home or your business. It's a far less secure proposition to "own" your own health plan. Ever since the New Deal, public policy in America has protected ordinary people against unforeseen risks, precisely so that they can take the deliberate risks of starting businesses and committing themselves to mortgage payments and becoming owners. Public policy has so given subsidies to lower-income people so that they too can get on the ladder to ownership. What Bush is really proposing is to shift economic risks back onto individuals—a time when other sources of economic security, such as long-term employment and stable pensions, are dwindling.

FOR HIS HEALTH PLAN, Bush wants to expand so-called Health Savings Accounts. These are tax-sheltered accounts tied to insurance with very high deductibles. By limiting the insurer's exposure, the approach allows for lower premiums. Health insurance would be delinked from employment, and people would freely choose what sort of insurance they wanted and use the Health Savings Accounts to pay the out-of-pocket costs. Said Bush in his acceptance speech: "These accounts give workers the security of insurance against major illness, the opportunity to save tax-free for routine health expenses, and the freedom of knowing you can take your account with you whenever you change jobs."

Sounds great. But there are four huge problems. First, the approach fragments the risk pool. Younger and healthier people would choose cheap, high-deductible policies, thus opting out of the broader insurance pool. Older and sicker ones would have to pay a king's ransom to get coverage. Second, individual policies are far more expensive than group policies to underwrite and administer, so the whole system could be less efficient. Third, the most cost-effective approach to health is prevention, but these high-deductible policies don't cover preventive care. So more people, especially those of modest means, would tend to skimp on prevention to save money. Finally, there's nothing in it for low-income people who lack the means to use a Health Savings Account, except for a tax credit so puny that it covers only about one-fifth the cost of decent insurance.

"Catastrophic" is an apt name for the whole approach.

The allure of owning your own retirement plan also demands a closer look. "We must strengthen Social Security," Bush said, "by allowing younger workers to save some of their taxes in a personal account—a nest egg you can call your own, and government can never take away." Sounds great. But the fellow proposing to take away part of the current Social Security guarantee is not "the government." It's Bush.

A recent Brookings study, *Coming Up Short*, by Alicia Munnell and Annika Sunden, is a searing indictment of "owning your own retirement." So-called defined-contribution plans, where the retiree has no assurance of a return, simply shift the risk from the employer or the government to the individual. The average 401(k) has assets to cover only a few years of retirement. It puts timing of retirement at the mercy of stock-market flukes. And in order to make plans safe from Enron-style corporate larceny, in which people are locked into company stock while it's tanking, it's necessary to have strong government regulation of the sort that Bush resists. By all means, let's encourage people to increase their retirement savings, but not, as Bush proposes, by

looting the one portion of the retirement system that is absolutely guaranteed—Social Security.

Look at American history, from the Homestead Acts to agricultural extension services, Federal Housing Authority loans, the GI bill, pension regulation, and public subsidies to health and education. The truth is that America's ownership society is built substantially on social investment and social insurance. It's certainly not built on shifting all risks to the individual. In spite of himself, President Bush has opened a useful debate about what it really takes for America to become a secure society of owners. ■

Robert Kuttner is co-editor of *The American Prospect* and author of *Everything for Sale*.

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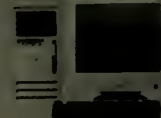
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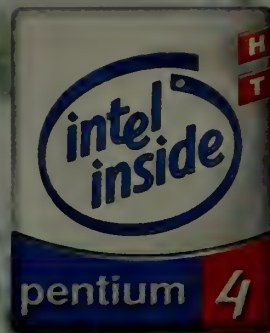
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BY STEPHEN H. WILDSTROM

Space-Age Sound Comes Down to Earth

It's often difficult for anyone you call on a mobile phone to hear you clearly under the best of circumstances. And mobile calls are frequently made under the worst of conditions—on street corners, from moving cars, in crowded malls. A new headset using advanced digital signal processing (DSP) technology can dramatically improve the quality of those calls.

The Jawbone headset, from Aliph, a Brisbane (Calif.) startup, is leading a wave of DSP-enabled consumer audio and imaging products. The technology, critical to CAT scans, customized hearing aids, and those spectacular photos from Mars, has been too exotic and expensive for the mass market—and in some ways it still is. The Jawbone is priced at \$149.95 (from jawbone.com) and is somewhat bulky—though attractive enough to win a silver in this year's *BusinessWeek*-sponsored Industrial Design Excellence Awards. But the relatively steep price is vindicated by a demonstration in which a Jawbone wearer's voice comes in over your cell phone as clear as can be, even though he's talking while running a gasoline-powered weed-whacker.

Conventional noise-canceling headsets, which have been on the market for some time, do a reasonable job of reducing some kinds of regular background sounds, such as the rumble of a car or the drone of your office ventilation system. The Jawbone, using an active noise-reduction system originally developed by Aliph for the military to use in armored vehicles, takes a different approach. It employs two microphones. One, which picks up vibrations from your jaw (hence the name), senses only your voice. The other picks up your voice and background noise. Some DSP magic compares the two and subtracts nearly all the noise, leaving only your voice. A switch turns the system on and off, letting the other party hear its amazing effectiveness.

THE JAWBONE CONSISTS OF TWO PARTS—the earpiece and a belt-clip processing unit that sits in the middle of a long, somewhat bulky cable between the earpiece and the phone. Because the unit's processor needs to draw power from the cell phone, it requires a special plug. And so far models are available only for Nokia, Motorola, and Sony Ericsson phones. Both drawbacks, however, should be temporary. To keep costs down, Aliph built the Jawbone using off-the-shelf programmable DSP chips. Once it goes into volume production, the company should switch to cheaper, more efficient, and



ALIPH
JAWBONE

much smaller custom chips. Then all of the electronics and a battery could fit into a relatively lightweight earpiece.

Jawbone is in the vanguard of a wave of products using advanced DSP technology to improve digital sound and image quality. (Oddly enough, to a computer, a photo and song represent much the same sort of data.)

Until now the most sophisticated signal processing has been the preserve of the military, scientific, and medical communities. That's changing fast. For example, a new line of Hewlett-Packard cameras, starting with the Photosmart R607, uses advanced signal processing to analyze the lighting of a shot

and improve the picture in the camera, eliminating much of the work that otherwise would be done on a computer. In essence, the technology NASA uses to enhance photos from space probes now comes in a \$300 camera.

Devices such as HP's camera will become commonplace. Better DSP will also bring improved quality to media

Digital signal processing used by NASA is now affordable

players of all sorts and to high-definition video transmitted wirelessly or over the Net. Today's signal compression takes toll on quality. But when video signals can be fine-tuned with more powerful DSP, images will look better and consume less bandwidth. Similarly, we'll be able to stream CD-quality music over relatively slow wireless phone networks. Signal processing is an arcane technology that goes back to the dawn of electronic communications, but it's starting to make a big difference in everyday products. ■

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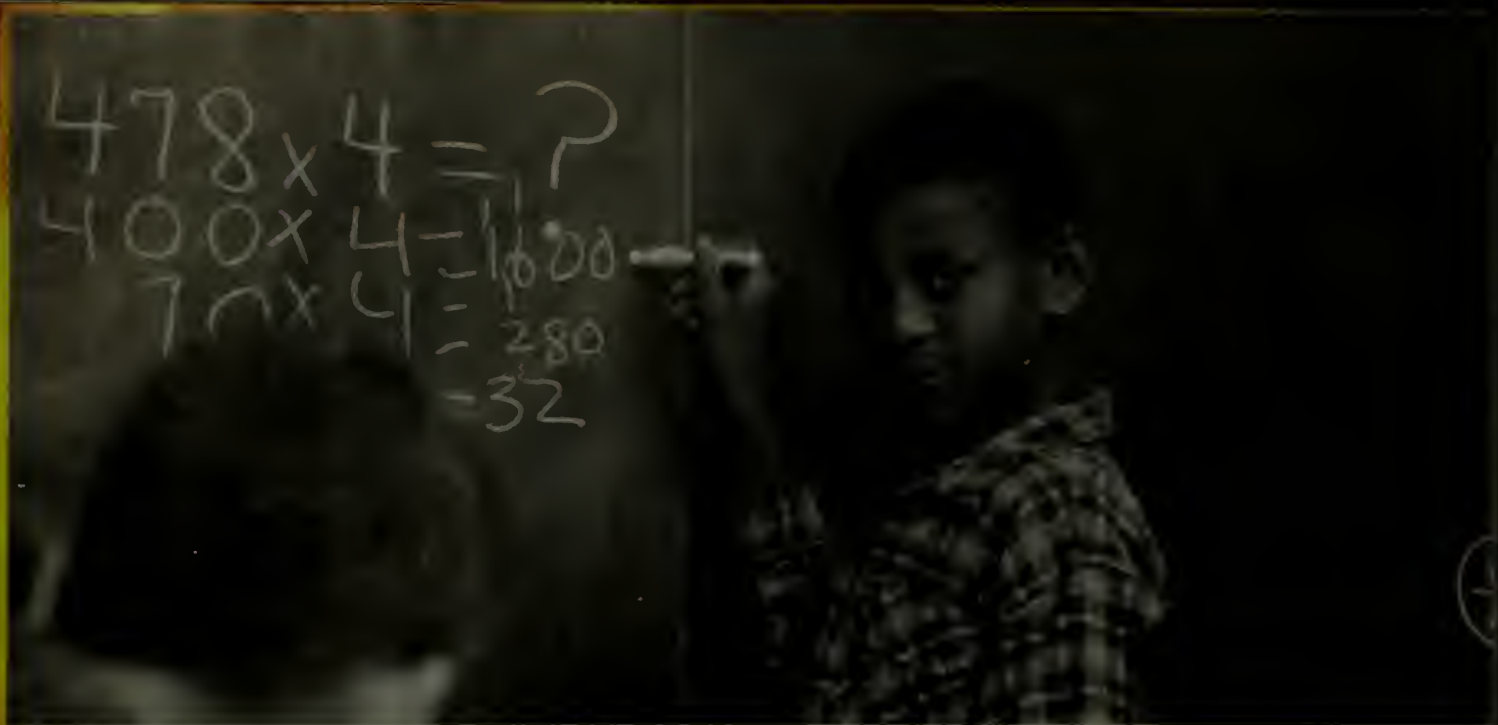
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BY JAMES C. COOPER & KATHLEEN MADIGAN

How the U.S. Is Riding Out The Energy Storm

broader demand plus lower inflation and interest rates help bolster growth

U.S. ECONOMY Soft patch? What soft patch? Looking at the economy's growth rate during the first three quarters of the year, it's difficult to see what all the fuss was about. Clearly, the pace of payroll gains and consumer spending slowed in the spring, but look at the overall result: Real gross domestic product grew 4.5% in the first

quarter, 3.3% in the second, and monthly data suggest growth in the 4% to 5% range in the third. Even with the drag from higher energy prices, real GDP for all of 2004 stands a good chance of expanding by 4% or better (table). It's not that costlier oil isn't having an impact. It most certainly is. Because the U.S. has net imports of about 10 billion barrels of oil and petroleum products annually, every \$10 per barrel rise in the price of oil diverts about \$10 billion of U.S. income to foreigners. That's income that otherwise would have accrued to households and businesses as wages or profits. Multiplier effects, as the higher costs travel through the economy, tend to increase the overall impact. A rise in oil prices from \$30 to \$50 is the potential to cut as much as one full percentage point from economic growth.

But to focus on oil is to miss a crucial point: Thanks to several key factors, this economy has managed to weather the energy storm so far. First, consider the timing of this latest oil spike. Unlike the \$20-per-barrel jumps in the price of crude in 1990 and 1999-2000, the current hike has occurred at the beginning of a business cycle, not toward the end of one, when the economy would be more vulnerable to shocks. Second, the recovery is broadening. Output is becoming less dependent on consumer spending as capital investment, inventory growth, and exports accelerate.

In addition, the oil spike has not pushed up other prices. Inflation, after scary jumps in the spring, eased back in July and August. Besides fueling a bond-market rally, that gave a lift to household buying power. Lower mortgage rates have buoyed housing and triggered a rebound in mortgage refinancing. Plus, despite being hit by higher costs and facing tough comparisons from the previous year, corporate profits last quarter are expected to post a solid double-digit gain.

OVER, MOST OF the economy's adjustment to higher oil has already occurred, at least with respect to gasoline prices. Based on the historical relationship between the quarterly averages of oil and gas prices from 1985 to 2003, crude oil at \$38 per barrel—its average in the second quarter—yields pump prices of about \$1.75 a gallon. But in this past second quarter the average gas

price was \$1.96 per gallon. That price is historically consistent with oil costing about \$46 per barrel, and the May peak in gas prices of \$2.06 implied oil at \$50.

Fast-forward to October. Gas is running about \$1.94, right in the range of what would be expected with crude oil at the \$45 to \$50 level. That suggests there is little reason to expect a big runup in prices at the pump. Even

HOW BUSINESS ECONOMISTS SEE 2005

	2004 ANNUAL AVERAGES	2005
REAL GDP	4.3%	3.7%
JOBLESS RATE	5.5	5.3
JOB GROWTH	1.1	1.7
PRODUCTIVITY	3.8	2.7
CPI INFLATION	2.6	2.3

Data: National Association For Business Economics

after considering higher prices for natural gas and heating oil through year-end, economists at J.P. Morgan Chase & Co. estimate that 70% of the impact of \$50 oil has already been absorbed in household spending. Despite that oil adjustment, consumer spending was still able to rebound strongly in the

third quarter. Real outlays appear to have grown in the ballpark of 4.5%, compared with 1.6% in the second quarter. That increase, along with positive trends in other GDP components, suggest real GDP will post growth in the 4% to 5% range when the Commerce Dept. makes its report on Oct. 29.

Car buyers weren't so strapped last quarter that they couldn't take advantage of a good deal. With generous sales incentives in place, carmakers sold autos at an annual rate of 17.5 million vehicles in September. That brought sales for the quarter to 17.1 million, the best quarterly showing of the year. The problem for the fourth quarter is that, if incentives fade, sales may drop.

AND WHAT ABOUT 2005? The chief worry is that oil, which topped \$52 per barrel on Oct. 6, could hold at \$50 into next year—or ratchet higher. The danger is not so much the hit to consumers but a new round of corporate caution and cost-cutting. That would threaten the rebounds in capital spending, inventory building, overseas demand, and—most important—job growth.

Economists, who gathered at the annual meeting of the National Association for Business Economics in

Philadelphia on Oct. 3-5, generally believe the economy has the momentum to advance at a solid pace for the rest of this year and next. The NABE's panel of forecasters project growth of 4.3% in 2004 and 3.7% in 2005. Those numbers are down from May projections of 4.7% and 3.8%, respectively.

However, when polled in early September, before the latest runup in oil, the economists said they expect the price of crude oil to fall to \$40 by yearend and to \$35 by the end of 2005. They also believed job gains in 2005 will average 220,000 per month, business investment will rise 9%, and 10% growth in exports will narrow the trade deficit slightly. Those forecasts look reasonable, but they should be taken with a big caveat. If the economists are wrong about oil, the other dominoes could fall as well.

THE CRUCIAL RISK in the outlook is how businesses would bear up under the increased cost pressure in the event crude prices don't settle down in coming months. In recent periods of uncertainty, corporations have acted quickly to protect their bottom lines. Indeed, one issue of the NABE survey was the role uncertainty is playing in the labor markets. The forecasters ranked "cautious CEOs" as the third most significant factor, after productivity gains and inadequate demand, holding back job growth. Heading into 2005 any corporate hesitation could delay not only hiring but also capital spending plans, possibly dealing a blow to economic growth.

Meanwhile, profits, although still growing solidly, are already set to slow for reasons other than energy.

Productivity growth has slowed, as it usually does when recoveries gain traction. And unit labor costs are rising faster, boosted partly by increasing health-care costs. Profit margins are high, but they are coming under some pressure, as the ability to push through cost increases remains limited. Pricier energy threatens to intensify the pressure on margins and earnings.

NO SIGNS OF A NEW ROUND OF LAYOFFS



Two indicators that would signal whether companies are pulling back are monthly orders for capital goods and weekly claims for unemployment insurance. Through August, the three-month average of capital goods orders, excluding aircraft, has plateaued at a high level but has not lost ground. And through September, the four-week average of jobless claims remains low, holding below 350,000 (chart).

So far, growth is holding up remarkably well with oil having first touched \$40 per barrel back in May. That's a tribute to the economy's underlying strength. But make no mistake, at some expensive level, oil prices will cripple this economy. What we might be in the process of learning is that the economy remains resilient enough to grow at a decent clip even with oil at \$50. ■

JAPAN

The Business Recovery Is Broadening

JAPAN'S CORPORATE sector is doing better than economists thought. That means the nation's recovery remains on track, despite \$50-per-barrel oil and slower global growth.

The Bank of Japan's widely followed Tankan survey showed vast improvement in business confidence in September. The index covering large manufacturers rose to 26, from 22 in June. The reading on large nonmanufacturers rose to 11 from 9, and even small businesses' sentiment improved, with the small manufacturers' index rising to 5 last month, from just 2 in June. Businesses also seem more willing to put their optimism into action. Capital spending among large firms is expected to

climb 6.1% for the fiscal year, which ends in March, 2005. That's up from 1.5% in 2003.

The readings beat the expectations of analysts and bolstered the idea that Japan's recovery is spreading from export-dependent big companies down to smaller businesses that cater to the domestic economy.

That notion also gained ground in the latest household data. Spending

by families headed by a salaried worker rose 3.6% in August from July. It was the first rise in four months. Japan's labor markets also improved in August. The unemployment rate fell to 4.8% from 4.9% in July, and the economy added 290,000 jobs.

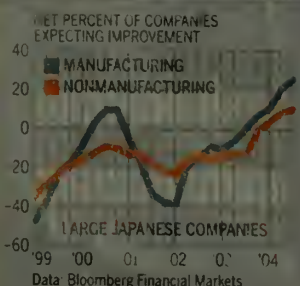
Japan needs better

domestic demand to offset weaker foreign trade. The trade surplus for August was lower than expected, as exports to the U.S. fell while the growth in shipments to the rest of Asia, including China, slowed.

Better domestic demand hasn't yet rid Japan of its deflation problem, even with rising energy prices. Consumer core prices, which exclude fresh food, were down 0.2% in the year ended in August.

The biggest risk to the outlook right now is the same danger for all developed economies: ever higher oil prices. Ifzal Ali, chief economist of the Asian Development Bank, warned that oil could go much higher than \$50 a barrel and that Japan's economy needs better domestic demand to maintain its recovery. If households must confront continually increasing energy bills, the worry is that the country's domestic demand might falter. ■

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BREAK  THROUGH

PHARMACEUTICALS

THE WANING OF THE BLOCKBUSTER

What's promising now are drugs that target niche diseases. That means painful restructuring ahead for Big Pharma

FOR A LOOK AT HOW THE drug industry is changing, compare the latest news on Big Pharma powerhouse Merck & Co., with \$22.5 billion in sales last year, and tiny biotech Medarex Inc., which racked up revenues of just \$11.2 million. Merck took a body blow when it pulled its popular arthritis drug Vioxx off the market on Sept. 30 because it increases the risk of heart attack and stroke in some patients; the move will instantly slice more than 11% from revenues. Nor does Merck have a new blockbuster waiting in the wings to replace it. Four of its most promising new drugs were dropped last year when they failed clinical testing.

Medarex, meanwhile, learned in early October that the Food & Drug Administra-

tion will speed up the approval process for the company's vaccine to fight advanced melanoma, now in late-stage trials. Two weeks earlier, Medarex announced a collaboration with Pfizer Inc., the world's largest pharmaceutical company, to develop up to 50 drug candidates over 10 years, on top of the 13 Medarex already has in clinical trials. And while Merck's stock fell from \$45 in early September to \$31.67 in the wake of the Vioxx news, Medarex shares almost doubled over the same period, from \$4.37 to about \$8.

RECALL RESISTANT

THERE'S A LESSON HERE. Pharmaceutical giants such as Merck have built one of the world's richest industries on blockbusters such as Vioxx that treat millions for the most common diseases. But the

most promising drugs in the pipeline now are designed for a much smaller slice of patients. Blockbusters they are not.

This change is a nightmare in the making for Big Pharma. Drugs that bring billions of dollars, such as Lipitor for high cholesterol, Nexium for hyperacidity, and Zoloft for depression, turned pharmaceuticals into one of the globe's most profitable industries, enabling drugmakers to spend \$32 billion on research and development last year and put 40,000 sales reps on the street. A shift toward less lucrative medicines means the world's massive drugmakers face wrenching restructuring that few are eager to embrace.

The exceptions are those that have already fallen out of the top tier. Bristol Myers Squibb, Abbott Laboratories, and Wyeth have all switched their efforts away

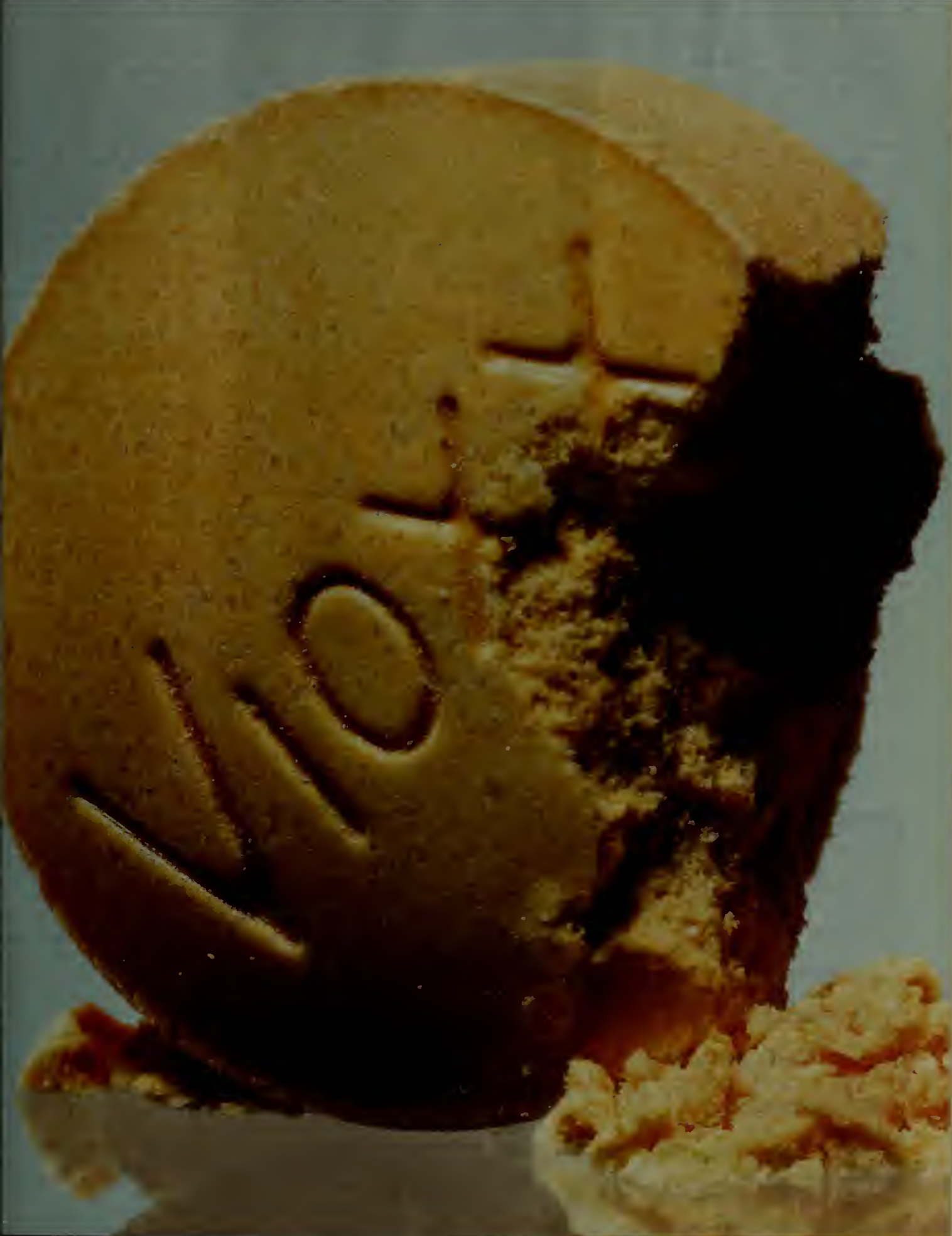
SO IN THIS SECTION:

2 Did AIG help clients deceive investors?

44 Good to grow: The global economy is up

46 The Significant Seven swing states

48 Fierce jockeying for D.C.'s new ball club



from blockbusters. Abbott has been the most drastic, downsizing from a focus on 13 areas in 2002 to just 5 today: immunology, oncology, neuroscience, diabetes, and antivirals.

NIMBLER LABS
R&D will have to get by on smaller profits

By developing drugs for less common medical problems, these companies hope to protect themselves from recalls. Patients on Vioxx could easily turn to another pain drug rather than risk a heart attack or stroke, no matter how small the risk. But Dr. James B.D. Palmer, Bristol-Myer Squibb's chief scientific officer, says a drug such as the one Bristol is developing to prevent organ-transplant rejections would have a captive patient group. They would likely be willing to accept more risk rather than go off an effective drug.

Vioxx highlights the dangers of staying the present course. It was designed to treat millions of people, but it turned out to also cause deadly side effects in some, just as Baycol, Bayer Group's cholesterol-lowering drug, and the diet drug Redux did before it. Merck now faces the prospect of the same massive lawsuits that hobbled Bayer and Wyeth, maker of Redux. Vioxx rivals such as Pfizer's Celebrex may also be in danger: European regulators plan to probe their safety.

MEDICARE HIT

BESIDES BEING RISKY, blockbusters may also lose their status as cash cows in the next few years. Once Medicare drug benefits start in 2006, pharma execs worry that the program will end up paying a set price for just one or two drugs for a given disease. Given that 50% of blockbusters are heavily marketed me-too drugs, offering little benefit over others in their class, the



industry is sure to take a financial hit. "Clearly," says Bain & Co. consultant Preston Henske, "the blockbuster business model is irreparably broken."

It's getting harder to come up with new blockbusters anyway. Pfizer will spend \$7.6 billion on R&D this year, but hasn't launched a blockbuster from its own labs since 1998. AstraZeneca PLC, still reeling from an FDA rejection in September of its Exanta anti-blood-clotting drug, said on Oct. 6 that a new diabetes drug will be delayed until 2007.

Scientists and industry consultants believe that the pharmaceutical industry will ultimately shift from blockbusters to targeted drugs, often referred to as personalized medicine. Getting to that future, though, will be a hard slog for the traditional kings of the drug industry. They are trapped in their own business model: the fully integrated company that tries to come up with widely used drugs for as many diseases as possible.

That model will become tougher to sustain. Though some drugs will still be relatively widely used, even they could see sales diminish through more careful targeting. Still, an arthritis drug like Vioxx with a diagnostic test that would screen out patients at risk of stroke could achieve huge sales, even if 20% of potential customers were eliminated. Companies might be able to make up for the loss of volume with a higher price. "We believe drugs will really have to show—in

order to get a premium price—much better benefit-to-risk ratio," says Dr. Nancy Simonia, senior vice-president of clinical development at the biotech firm Millennium Pharmaceuticals Inc. "The way to do that is identify the patients who get the greatest benefit."

In place of one or two blockbusters, pharma companies will have to churn out three or four \$300 million to \$500 million drugs. To survive, drugmakers will have no choice but to streamline R&D and sales, focusing on just a few diseases. They will also have to be more aggressive about forming development partnerships, such as the Pfizer-Medarex pact.

OFF-PATENT DESERT

MOST OF BIG Pharma remain understandably hooked on blockbusters. Boston Consulting Group estimates that 80% of growth for the 10 biggest drug makers during the last decade came from the eight or so blockbusters a year launched during the 1990s. That pace has slowed to almost nil since then, however, and many of the best-selling drugs from the '90s will go off patent soon. The major drugmakers' lack of new drugs stands in sharp contrast to the biotech industry. Boston Consulting reports that the hundreds of tiny biotech firms, while responsible for only 3% of the drug industry's total R&D spending, can lay claim to 67% of the drugs in clinical trials. Almost all are personalized drugs.

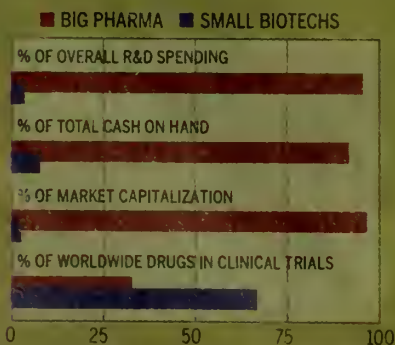
Big drugmakers insist that they see the rise of targeted drugs. But most also agree that blockbusters are far from dead. "Personalized medicine" is a laudable aim, but we are not anywhere near there yet," says Dr. Declan P. Doogan, Pfizer head of medical and development science. "I think biotech has investigated some niche disease areas with targeted approaches. But it is in the early days."

Not that early. Already, targeted therapies are on the market for cancer, allergies, and rheumatoid arthritis, and many others are in development. The sooner Big Pharma gets behind personalized medicine, the sooner the industry will regain its ability to innovate. And that would be the best news for patients.

—By Catherine Arnst in New York, with Amy Barrett in Philadelphia, Michael Arndt in Chicago, and John Carlin in Washington

LOSING THE EDGE

Big Pharma* has big bucks but lags smaller biotechs in promising new drug development:



*INCLUDES TRADITIONAL PHARMACEUTICAL COMPANIES AND THE TEN LARGEST BIOTECHNOLOGY OUTFITS

Data: Boston Consulting Group

HARMACEUTICALS

OFF-LABEL'—AND OUT OF BOUNDS?

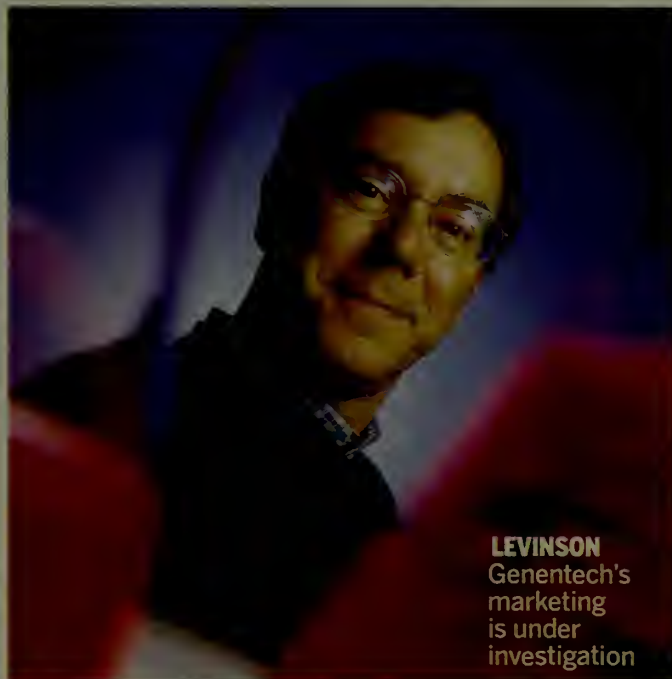
When drugmakers promote products for unproven uses, they may be courting trouble

ON OCT. 5, GENENTECH INC. DISCLOSED that the U.S. Attorney's office in Philadelphia was investigating the marketing of one of its drugs. Neither the feds nor the company would provide details, but many observers believe the inquiry is focused on whether Genentech, led by CEO Arthur D. Levinson, improperly marketed the cancer drug Rituxan to combat cancers other than those approved for treatment by the Food & Drug Administration. Such "off-label" uses seem to be attracting increasing scrutiny these days. Johnson & Johnson and Cephalon Inc., too, are being probed for possible marketing

violations believed to be connected to off-label uses.

On the face of it, using drugs to treat diseases they weren't designed and tested for seems risky—yet another example of the overzealous marketing for which drugmakers are increasingly criticized. But the issue is more complicated than that. In an effort to help patients, doctors commonly try medicines in new ways, even if the drugs haven't been rigorously tested for those diseases. That raises real questions about whether patients are being used as guinea pigs and how drugmakers should spread the word about promising new treatments. The law bans them from actively marketing drugs for off-label uses. But with the lure of additional sales, companies have a powerful incentive to push the envelope. Here is a primer on the issue and the larger concerns it raises:

Why are drugmakers being investigated? Genentech's drug Rituxan was approved only for patients with slow-growing non-Hodgkin's lymphoma who have relapsed or failed to respond to other drugs. Scientists have been testing Rituxan in other blood cancers, with some promising results, prompting doctors to prescribe it more widely. But if Genentech is actively



LEVINSON
Genentech's
marketing
is under
investigation

promoting the drug for those new uses, it's breaking the rules. J&J is being investigated for off-label promotion and sales of several drugs, including Procrit, which is used to treat anemia.

But if a drug does work for other diseases, shouldn't doctors get the word?

Yes. Medicine clearly advances when re-

searchers find new uses for drugs. And arguably, companies are well placed to spread the information. Currently, industry sales reps can give doctors copies of studies on unapproved uses if the reports appear in peer-reviewed medical journals.

So where's the problem?

Companies may push drugs for off-label uses harder than the evidence warrants. Even if they follow the rules and only hand out journal articles, drugmakers may be spreading half-truths, since they aren't bound to distribute less favorable studies. The industry has often flouted the rules. This year, Pfizer-owned Warner-Lambert pleaded guilty to criminal charges that its Parke-Davis division illegally promoted its epilepsy drug Neurontin for a host of other disorders, turning it into a blockbuster. Among other dubious practices, the company paid doctors to give presentations and write articles heralding unproven uses. It agreed to pay \$430 million in penalties.

Does the practice harm patients?

Potentially, and in two different ways. Individual patients can be hurt if a drug they're given doesn't work. Medical knowledge can also be a casualty. If companies can get docs to prescribe a drug for unapproved uses, the industry has little incentive to do the clinical trials that would prove whether it actually is effective.

What's the solution?

There are no easy answers. Some experts say regulators should ban dissemination of information about unapproved uses. Courts, though, have ruled that companies have a constitutional right to give information to doctors. While the FDA should make it easier for companies to perform the clinical trials needed to get approval for new uses, that won't resolve all the problems. Sometimes companies play a useful role, spreading the word about promising new uses of their drugs. Other times, they cross the line in their quest for fatter profits and need to be reined in by regulators. ■

—By John Carey in Washington, with Amy Barrett in Philadelphia

EXCHANGES

Market Lessons From Merck's Decline



MATCHMAKERS NYSE specialist Barry (left) and ECNs together reduced volatility

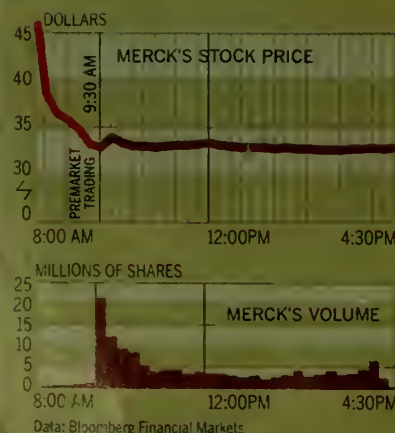
When Merck & Co. announced the morning of Sept. 30 that it was recalling its Vioxx pain medication, it caused a huge headache for patients and investors. But they weren't the only ones reaching for the aspirin. The pharmaceutical giant also created an enormous task for Wall Street's stock dealers and brokers. In the scant 75 minutes between Merck's 8:15 a.m. announcement and the scheduled opening of the New York Stock Exchange, and the frenzied hours immediately afterward, traders had to field an avalanche of orders.

If the dealers and brokers couldn't match buyers and sellers quickly, or if they completed the trades at wildly divergent prices, their already-riiled customers would be furious. They also knew that the Securities and Exchange Commission would be closely watching. The SEC is debating whether investors are best served by the NYSE's auctions conducted by "specialists" on the exchange floor or by rival electronic systems that use computer programs to automatically match up traders with buy and sell orders for many NYSE-listed stocks.

So what's the verdict? Essentially, a tie. Overall, both the NYSE and the electronic systems did their jobs. Both played key roles in piloting Merck's badly damaged stock to a relatively smooth emergency landing. The

electronic exchange helped take down the price before the NYSE opened. And the NYSE completed the job with huge block trades throughout the day. Despite trading more than 144 million shares—20 times the normal daily volume—volatility was essentially kept in check after a quick 27% plunge gobbled up \$27 billion in market capitalization. The shares, after closing at \$45.07 the night before, opened on the NYSE at 9:32 a.m. at \$33 each and traded in a remarkably tight range of \$32.46 to \$34.02 for the next seven hours, before closing right back at \$33.

STEADY AS SHE GOES



The performance was so good that John A. Thain, CEO of the NYSE, is touting it as evidence of the superiority of the exchange's system of floor auctions. "The specialist was able to find a price that was fair for both the buyers and the sellers, which is what led to the market being fair and orderly," says Thain. In the opening trade, the specialist assigned to Merck, James J. Barry of LaBranche & Co., matched up buyers and sellers of 5.7 million shares. He bought about 10% of those shares himself for LaBranche, helping make up for a shortage of buy orders, according to the NYSE.

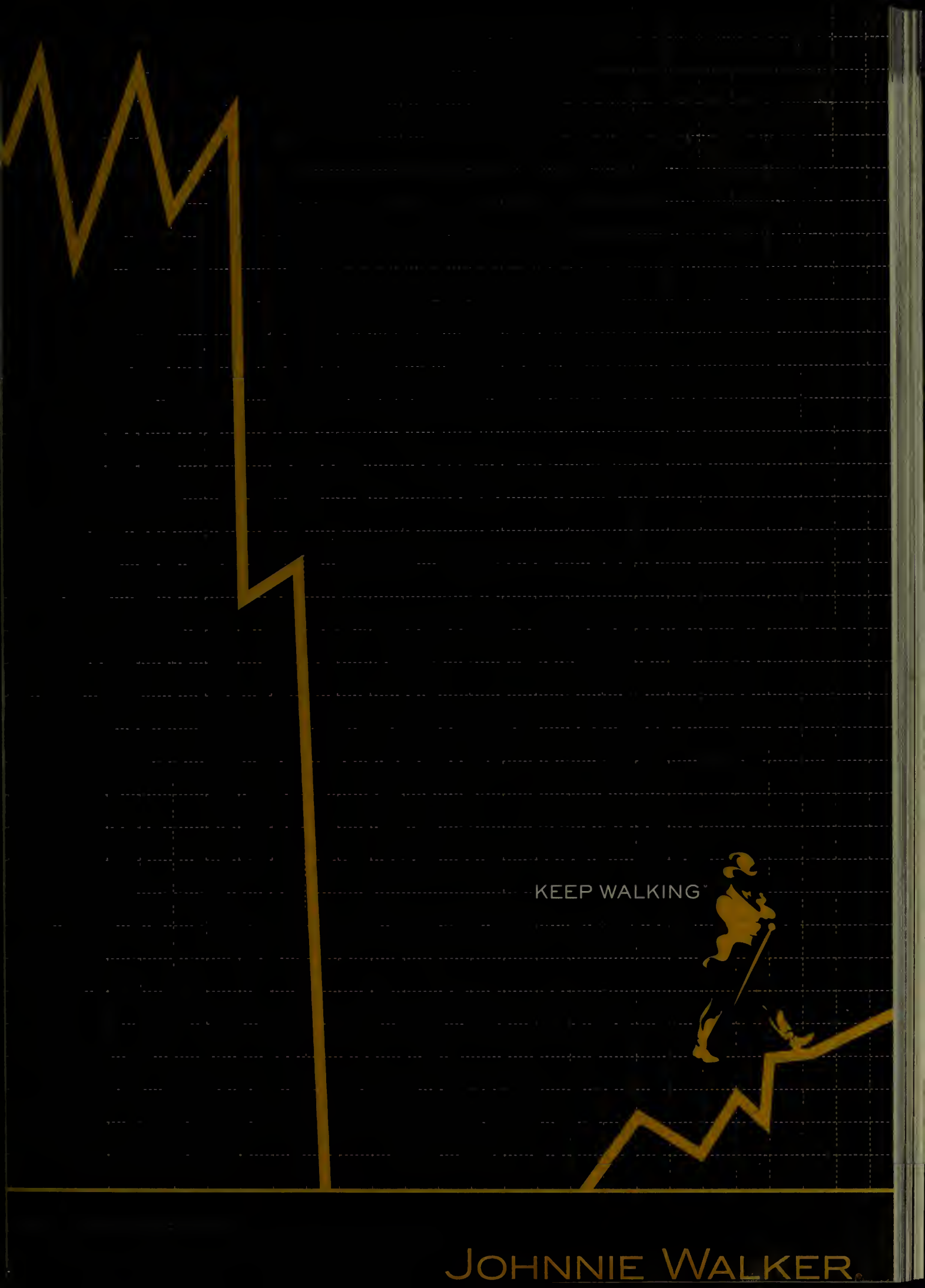
But the two big electronic systems, Archipelago Exchange and INET, say they also deserve credit for finding the \$33 level that satisfied so many buyers and sellers and opened the way for the flood of trades. Indeed, the ECNs, already open when Merck broke the news, were the first responders. They traded about 10 million shares before the NYSE opened, walking the price down through small trades to the NYSE opening price. Archipelago President Michael A. Cormack believes key electronic trades came from savvy investors who knew Merck well enough to figure out it was worth about \$33 without Vioxx. "Our clients essentially discovered the price long before the (NYSE) specialist became involved," he says.

Not surprisingly, Thain doesn't see it that way. He argues the specialist's ability to choose \$33 as the opening price came from much bigger orders queuing up on the NYSE floor. But the pattern of steadily declining prices on trades that Archipelago posted to the public before the NYSE opened shows the electronic system was important. Those early trades helped chart the course for the stock price and the big volume that followed.

The NYSE rivals handled 35% of the shares and dollar value of Merck trading for the day, almost double their usual 20% share of the volume in NYSE-listed issues. That's because when stocks are under the stress of sudden news, buyers and sellers tend to turn to the electronic systems to quickly buy and sell in smaller volumes. "People crave electronic markets when things get tough," says Cormack.

Still, the NYSE carried the big loads. The average trade on the NYSE for the day was 11,000 shares, more than twice that on Archipelago, according to the NYSE. Amid that pressure, the NYSE specialist kept the average spread between bid and ask prices, a key measure of trading costs, down to just 3¢. While both sides want to claim victory, the day showed that investors aren't best served by one system or the other. They're best served by having both.

—By David Henry in New York



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INVESTIGATIONS

AIG: WHY THE FEDS ARE PLAYING HARDBALL

It says it's cooperating with the SEC and Justice, but evidence suggests otherwise

AERICAN INTERNATIONAL Group Inc. is among the largest and most profitable companies in the world, with \$81.3 billion in revenues and \$9.3 billion in earnings last year. Chairman and CEO Maurice R. Greenberg is one of Corporate America's most powerful execs, overseeing a financial empire with some 90,000 employees peddling everything from insurance to asset management in 130 countries. But those numbers aren't getting Greenberg much respect in the halls of the Securities & Exchange Commission or the Justice Dept.

AIG is seriously on the outs with both law enforcement agencies. The trouble seems to have begun on Sept. 21, when the SEC informed AIG that it may bring civil securities-fraud charges against it for allegedly helping PNC Financial Services Group Inc. hide underperforming loans in 2001. Eight days later, the Justice Dept. told AIG that it is under criminal investigation for the same deals. Things got noticeably worse on Oct. 4, when both Justice and the SEC warned AIG that it may have misled investors when it issued three press releases that allegedly failed to reveal the full scope of the probes.

That makes four warnings in three weeks from agencies not usually known for quibbling over the wording in company press releases. AIG says it intends to cooperate—but in its latest statements it still contends that any action by the two agencies “would be unwarranted” and that charges it misled investors are “without merit.” The complaints about AIG's press releases boil down to this: The company said it was under investigation for certain deals, “including three transactions” with PNC—but failed to mention that the investigations also covered five

additional deals with two other insurers.

This is no mere quibble over wording. Law enforcement sources believe AIG helped its corporate clients deceive investors by selling insurance products or creating off-balance-sheet entities that have the effect of downplaying losses or overstating earnings. Just as important, current and former law enforcement sources say they're taking a tough stance with AIG because they believe it plays “hide the ball” by allegedly resisting requests for documents, e-mails, and other information from SEC and Justice staff. And when it's required to disclose investigations, they add, AIG downplays their seriousness in public statements. An AIG spokesman responds: “Any allegation of a breach of [responsibility and integrity] is of deep concern to us, and we look forward to presenting our case in the proper forum.”

POST-ENRON SCRUTINY

IF AIG IS PLAYING GAMES, the agencies are playing hardball. Post-Enron, investors look to them to protect their interests, and congressional overseers holler if they fail. “We're in an environment where regulators have to be aggressive, in part because they were accused of not being aggressive enough in the past,” says John P. Waterman, chief investment officer at Rittenhouse Asset Management Inc., which has about \$390 million in AIG stock.

In securities-law-speak, AIG is under investigation for aiding and abetting securities fraud. The charges echo those that Merrill Lynch, J.P.Morgan Chase, and Citigroup all settled last year without admitting or denying guilt, for what the SEC said was financial wheeling and dealing that

allowed Enron Corp. to hide troubled assets and disguise loans as income. For Merrill bankers are on criminal trial in federal court in Houston on charges helping Enron in late 1999 hide its ownership of electricity-producing barges parked off the coast of Nigeria and book an extra \$12 million profit.

AIG's woes date back to the same go-go years—and began with a similarly trifling amount of money. In July, 2000, the SEC first began investigating the insurer's role in helping Brightpoint Inc., a Plainfield (Ind.) distributor of mobile-phone data and services, hide \$12 million in losses. In 1998, say SEC documents, Brightpoint

Why **AIG** Is on the Outs

SUSPECT PRODUCTS

The SEC alleges that AIG sold products that let clients avoid losses or smooth earnings. It says a fake insurance policy helped Brightpoint disguise \$12 million in losses in 1998. A special-purpose entity in Financial Services Group hid problem loans in 2001.



discovered that a British unit's losses could be twice what Brightpoint had publicly announced, so it sought help from an AIG subsidiary, the Loss Mitigation Unit of National Union Fire Insurance Co. of Pittsburgh, Pa.

The insurer had just what Brightpoint needed: a retroactive insurance policy for which Brightpoint would pay monthly premiums for three years, say the documents. During that period, the AIG unit did the money back in the form of insurance claims. Brightpoint recorded those payments as insurance receivables in 1998 to offset that year's losses. The round-trip payments were cleverly disguised within a legitimate insurance policy, the SEC said in

a September, 2003, settlement of a civil fraud action against Brightpoint and two ex-managers. Without admitting guilt, the company and its two officers paid total penalties of \$595,000.

But the SEC also fined AIG \$10 million, which it paid without admitting guilt. The SEC probe uncovered evidence that allegedly showed AIG had created and marketed the Brightpoint "insurance" to help its clients smooth quarterly earnings. The SEC also believes AIG stonewalled its probe because AIG's own accountants had designed the policies to fool auditors into believing they were traditional insurance policies.

Why does the SEC think that? The SEC documents say that more than two years after the Brightpoint probe began and after several rounds of subpoenas, AIG finally handed over an internal white paper, written in 1997 by an AIG accountant and circulated widely

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among AIG's top insurance-unit managers. The paper outlined a new type of "nontraditional" insurance product.

Its main attribute: "income statement smoothing" using retroactive insurance that let clients recognize losses over several reporting periods—exactly what AIG did for Brightpoint. The paper, says an SEC document, conceded that accounting rules were designed to avoid such a smoothing effect and outlined ways to avoid such "unintended accounting...consequences." AIG, the SEC says, marketed the new products on a large scale.

CAUGHT IN A LIE

YET IN SEPTEMBER, 2002—a month before the SEC obtained the paper—AIG lawyers had told the SEC Enforcement Div. that the Brightpoint policy was the result of errors by a junior-level worker without proper training. Then, after the smoking gun turned up—the SEC won't say how—AIG gave sworn certification that it had produced all relevant documents.

Again not true, says a person with knowledge of the case. "AIG failed to conduct an even remotely reasonable search, such as checking the files and computer drives," says this source. The SEC issued another subpoena, and a welter of new

documents was finally delivered—some as late as January '03.

Now the SEC is chasing new leads, including the PNC case. There, PNC avoided writing down \$762 million in underperforming loans and sour venture-capital deals by shifting them to an off-balance-sheet entity

formed with the help of a different AIG unit. That let PNC show earnings in 2001 that were 52% rosier than they would have been without the special-purpose vehicle. The SEC in July, 2002, alleged that the structure violated accounting rules because PNC still was on the hook for the problem assets yet didn't reflect those risks on its balance sheet. PNC settled Justice and SEC charges without admitting wrongdoing.

Even if AIG is downplaying the probes, investors aren't. The shares have dropped 6.5%, to \$66.60, since Sept. 20. Now that Justice and the SEC are working hand-in-glove against the finance giant, its woes may be just beginning. ■

—By Paula Dwyer in Washington, with Diane Brady in New York

Enforcement sources say AIG has withheld documents again and again

OPERATIVE VIOL

a \$10 million fine in part for allegedly withholding crucial documents in the Brightpoint case. AIG denies the charge.

MISLEADING INVESTORS

AIG issued several press releases that Justice Dept. and SEC officials say downplayed the scope of their probes. After warnings, AIG revealed that it's also under review for five more deals with two other insurers, and not just three PNC deals.



SINGAPORE Trading partners import China's growth but not its rising prices

how long China can maintain this tricky balancing act of being both a source of growth and of disinflation for the rest of the world economy. Already, some danger signs are starting to emerge. Inflation is rising in China, and trade frictions with the U.S. are growing in response to the communist giant's super-charged export juggernaut. While the forces that are currently keeping China aloft and global inflation under control may not reverse anytime soon, the risks are clear. "The situation is not sustainable," according to

former IMF official Morris Goldstein, now at the Institute for International Economics, a Washington think tank. "Something has got to give."

Indeed, China's economic development strategy is causing strains of its own. In 20 short years, China has gone from a deflationary pricing environment to annual inflation of 5.3% in August. Behind the marked turnaround: pell-mell economic growth, an ultra-easy monetary policy, and a bank lending boom. Perhaps even more surprising in a nation of 1.3 billion people, there have even been reports of spot labor shortages in China and rising wages.

HUGH CAPACITY

SO WHY ISN'T China exporting its inflation to the rest of the globe? Credit largely goes to its massive investment in capacity. With investment running at some 45% of gross domestic product, China is adding capacity at a furious pace to make everything from steel to cell phones. Yes, its appetite for materials to fuel those factories is pushing up prices for oil and other commodities. But its exports of cheap consumer goods from those factories hold down inflation in the U.S. and elsewhere.

That huge build-up holds risks of its own, and the Chinese authorities have

THE GLOBAL ECONOMY

HIGH EXPANSION. LOW INFLATION. WHAT GIVES?

China's boom, heady investment, and growing trade make for a potent combo

THE WORLD ECONOMY IS cooking. Global output will expand 5% this year, the International Monetary Fund predicts—the biggest rise in nearly three decades. The U.S. has pulled out of a slowdown earlier this year and looks set to post 4%-plus growth in the third quarter. China is likely to grow a sizzling 9% this year, and Japan is enjoying its best performance since 1990. Even long-lagging Europe is looking up.

In the past, such a strong, synchronous upswing would have set off inflation-phobes' alarm bells. Indeed, stronger demand has pushed up prices of global commodities, and especially oil. But so far, those price hikes haven't sparked broad-based inflation. Excluding food and energy costs, consumer price inflation worldwide is running at less than 2.5%, IMF data show.

So, what's going on? Over the past decade or so, the global economy has un-

dergone fundamental changes that are conspiring to boost growth while keeping prices in check. These shifts include the continuing productivity revolution in the U.S. as well as the determination of the globe's central banks to keep prices under control. But the mother of all change agents is China—a rising economic power whose soaring demand is fueling growth across the globe, even as its surge in low-cost manufacturing exports on the back of an undervalued currency is helping keep inflation in check from Des Moines to Düsseldorf.

The question facing policymakers is

Firing on All Cylinders

The world economy looks set to clock its fastest growth in nearly three decades

EUROPE	U.S.	JAPAN	ASIA
+2.6%	+4.3%	+4.4%	+5.5%

ed jawboning and other administrative measures to try to rein in the nation's investment boom. The growth of fixed investment has slowed somewhat: From a % annual pace in January, it fell to .2% in August. Still, that's an enormous amount of investment in the pipeline, and China will need years to put all the capacity to use. "This is a process that will work out over years, not quarters," says China expert Nicholas R. Lardy, also of the Institute for International Economics.

TALIATION?

CHINA'S EXPORT-DRIVEN strategy is promoting strains in its trade ties with the U.S. as well. The U.S. trade deficit with China jumped 28% in the first eight months of 2004, fanning political pressure in Washington for retaliatory action against Beijing. If that happened, it could trigger a nasty trade war that would undercut the global economy.

China has resisted the one step that economists say would help it curb its trade surplus with the U.S.: revaluing its currency. Allowing the yuan to rise would cut the prices of its raw material imports while raising the prices of its exports. At the G-7 meeting on Oct. 1, Chinese policymakers rebuffed U.S. calls for a timetable to adopt a more flexible currency system. But Washington is unlikely to back off—especially if the end of textile quotas in January allows China to dominate completely the global apparel industry; that will almost certainly prompt more calls for yuan revaluation.

While an eventual rejiggering of the Chinese currency would narrow the American trade deficit, the news wouldn't be all good. Chinese goods would quickly fetch higher prices, bringing an end to the nation's deflationary role. And if other Asian nations followed Beijing's lead and allowed their currencies to rise—as many experts think they would—the jolt to global inflation could prove significant. So far, the reconfiguration of the world economy around the U.S. and China has proved to be a net plus. The change has helped hold down inflation levels even as it promotes global growth. But it has also spawned economic imbalances that will need to be dealt with if the good times are to continue. ■

—By Rich Miller, with Pete Engardio, in Washington, and Dexter Roberts in Beijing

CURRENCY

Untying the Yuan Would Get China Out of a Bind



HOT MONEY Is it spurring inflation?

Again and again during a weekend of meetings in Washington on Oct. 1-3, People's Bank of China Deputy Governor Li Ruogu heard the same plea from world financial leaders. For the sake of the global financial system, implored officials from the U.S. Treasury Dept., the International Monetary Fund, European banks, and economic think tanks, China's central bank must loosen its grip on its currency. By keeping the undervalued yuan pegged at 8.28 to the U.S. dollar, China is making it impossible for the U.S. to cut its \$600 billion balance-of-payments deficit and is forcing other nations to intervene in their currencies.

But everywhere he went, Li delivered the same message Beijing has given for years: "We are moving toward a more market-based, flexible exchange rate." And when? Don't hold your breath. Given China's shaky financial system and the disasters in Thailand, South Korea, and Russia after they dismantled capital controls, it's not surprising that China isn't about to let foreigners dictate its currency policies.

With each passing month, though, China's argument for maintaining its rigid link to the greenback grows weaker. The biggest reason is the financial pressure building in China's domestic economy. Every month China records a net inflow of

some \$10 billion from export earnings, foreign investment, and borrowings. As a result, China's foreign reserves have swelled from \$212 billion to \$471 billion in less than three years. The People's Bank invests most of these dollars in U.S. Treasury bills. But to prevent inflation and keep the peg, the central bank must also "sterilize" the inflows by selling an equal sum of yuan-denominated bonds to local banks. Experts say there's a limit to how much of this paper the central bank can unload without hiking rates.

The dollar peg also makes it hard to cool the overheated economy. The best way would be to raise lending rates, which have stayed at 5.3% for a decade. But the PBOC can't raise rates much higher than U.S. rates. Otherwise, even more dollars would gush in as Chinese companies boosted borrowings of cheaper money from abroad.

Indeed, the IMF worries, the low yuan already is fueling big inflows of hot money. Until 2002, almost all of the balance-of-payments surplus could be accounted for by foreign direct investment (FDI). But last year, FDI equaled just 40% of the surplus. The remainder, economists surmise, is from Chinese companies, foreign-owned factories, and individual investors bringing in dollars now, while Chinese assets are cheap, before the yuan rises. So although Beijing has forced banks to curb lending, overinvestment in everything from office towers to TV factories roars on, thanks in part to speculative funds from abroad. "The administrative controls aren't working, because everyone is finding ways to circumvent the banks," says Joyce Chang, head of emerging-market research at J. P. Morgan Securities Inc.

How does China get out of the jam? Letting the yuan appreciate by a good 15% and then fluctuate within a band would probably cool the speculation and move the currency close to a market rate, figures Nicholas R. Lardy of Washington's Institute for International Economics. Such a sudden jolt is unlikely. But at the least, China should start moving gradually in that direction while its economy remains strong—and any pain can be absorbed.

—By Pete Engardio in New York

CHINA	WORLD
9.0%	+5.0%

* Estimated 2004 GDP growth ** Newly industrialized
Data: International Monetary Fund

COMMENTARY

BY RICHARD S. DUNHAM

A Tricky Political Triage

Bush and Kerry find they must home in on just seven decisive swing states

FOR MONTHS VOTERS have been told that the November election will be decided in 12 to 14 swing states. But as Campaign 2004 hits the homestretch, a new reality has dawned. For George W. Bush and John Kerry, the race has come down to a fight for little more than a handful of still-competitive states. Barring a pratfall in one of the last debates, a terror attack, or a

major blowup in Iraq—which could dramatically alter the race—the man who nabs most of these states' electoral votes will win the Presidency.

Call them the Significant Seven: Florida, Iowa, Ohio, New Hampshire, New Mexico, Pennsylvania, and West Virginia. If the race remains tight and neither candidate moves solidly into the lead, these seven are where the action is. That's why both campaigns are juggling resources, pulling ads in states that are slipping away, and concentrating media and manpower where it can do more good.

Late-season triage is a hallmark of most campaigns. But it's a tricky business knowing when to fold the tent. Four years ago, Al Gore ditched Ohio for friendlier climes. But on Election Day, his populist message resonated, and Gore lost the state by a mere 3.5 percentage points, leaving political pros to ponder what might have been. The move "cost him the election," says GOP consultant Scott W. Reed.

Today, Bush and Kerry confront similar decisions—where to play and where to pull out and disappoint state partisans. "This is the time when candidates get to the fork in the road," says Reed. "Targeting resources is the name of the game."

For Kerry that means scaling back what was once a 20-state campaign. The Democrat has pulled ads from Arizona, Colorado, Missouri, North Carolina, and Virginia. Bush, who had a smaller list of showdown states, is paring his efforts in Washington and may soon have to decide if he should limit his activities in Michigan and Oregon.

Either Bush or Kerry can guarantee a win by capturing two of the "Big Three" toss-ups: Florida (27 electoral votes), Ohio (20), and Pennsylvania (21). But the President could still gain an Electoral College majority if he picks up just one of the three sweeps the remaining four up-for-grabs states, and holds on to Wisconsin, which Gore narrowly carried in 2000. Kerry doesn't have that luxury: Running behind in once-promising states such as Missouri, he must carry Pennsylvania and one of the other Big Two to have a shot.

No place is getting more attention than Ohio, host of the Oct. 5 Vice-Presidential debate. Kerry has spent 26 days in the Buckeye State since January, opened 55 field offices, and hired 77 organizers. President Bush made the 27th trip of his Presidency to Ohio on Oct. 2 and has a huge organization there.

Both candidates' TV ads saturate the airwaves. Ohio boasts four of the five top markets for Presidential commercials: Cleveland, Columbus, Dayton, and Toledo, according to Nielsen Monitor-Plus and the University of Wisconsin Advertising Project.

The Significant Seven give both candidates reason to cheer—and worry. Kerry's backers fret that the dwindling list of targets means that more Gore states are in play than former Bush bastions. But Republicans remain concerned because the President has not yet snagged two of his 2000 trophies: Ohio and Florida.

What's more, Kerry has been outpolling Bush in the seven remaining winnable states. By comparing the candidates' performance in state polls since July

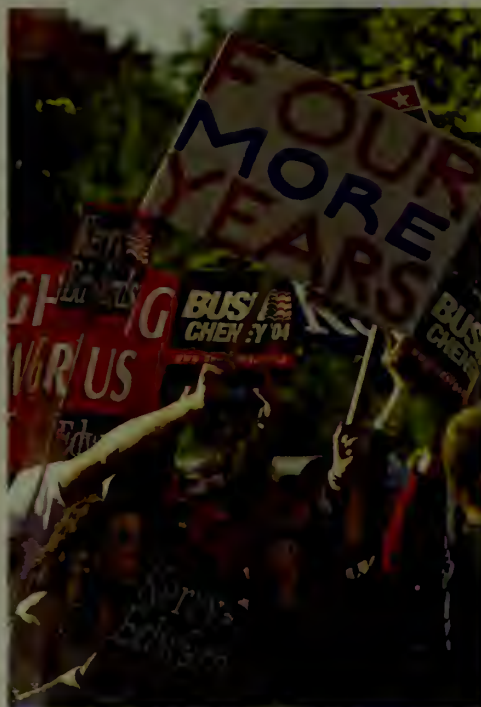
1 to national surveys taken at the same time, *BusinessWeek* found that in Florida, Kerry had a 0.7 percentage points lead, while in Ohio he was 1.5 points ahead.

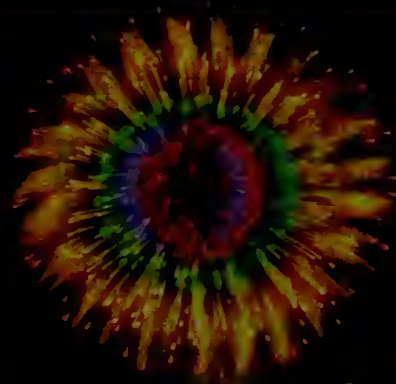
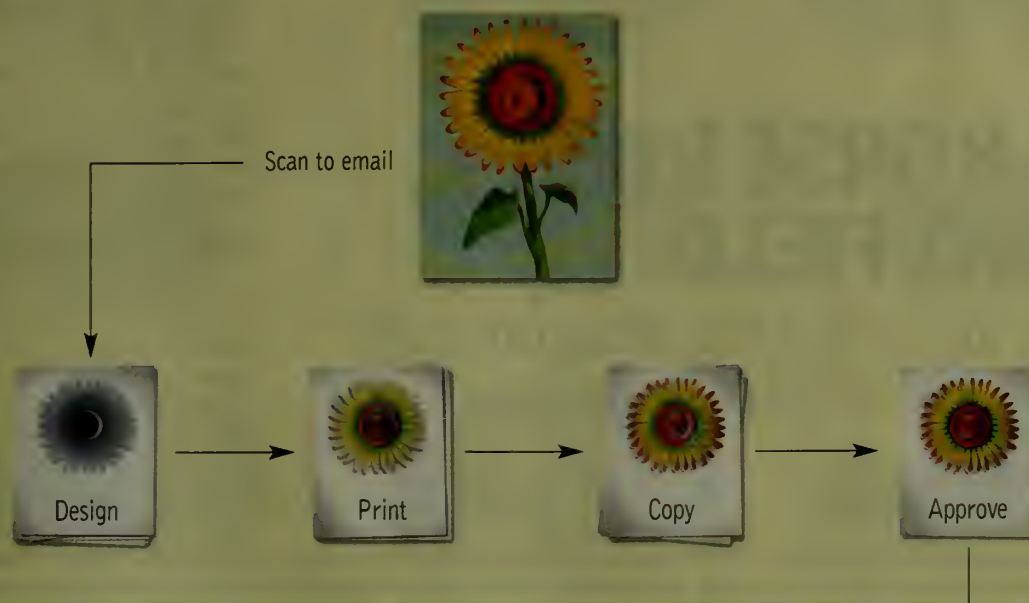
CLEVELAND No state is getting more attention than Ohio

his nationwide backing. Kerry has picked up an extra 1.5 points in Iowa, 5.1 in New Hampshire, 5.3 in New Mexico, and 4.1 in Pennsylvania. Bush has run ahead of his national pace only in Ohio (by 2.5 points) and West Virginia (3.3). In a dead-heat election, that would give Kerry a slim Electoral College advantage.

Surely, seven is going to be someone's lucky number come Nov. 2. But with charges, countercharges, and the fog of war clouding the Presidential battlefield, it's too early to say whether Bush's or Kerry's final drive will succeed. ■

—With Lee Walczak in Washington





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BASEBALL

IT'S A HORSE RACE IN RIGHT FIELD

The jockeying to win Washington's new team gets fierce. It'll take more than cash

THE BIGGEST GUESSING game in Washington—after who will be the next President—is: Who will win the capital's new baseball team? For now the answer is as tough to predict as the date of Roger Clemens' real retirement party. Far from winnowing the field of wealthy lawyers, bankers, and real estate speculators, MLB's yet-to-be-ratified decision on Sept. 29 to move the Montreal Expos to D.C. has brought out new bidders and fresh money.

Washington Baseball Club, a heavy-hitting team of D.C. insiders, has been pursuing the Expos the longest. The group, which began chasing a franchise in 1999, includes Presidential pal Frederic V. Malek; Fannie Mae Chairman Franklin D. Raines; and Washington power broker Vernon Jordan.

Other investors swinging for the team, which could be in the new owners' hands before Opening Day, 2005, include groups led by Long Island real estate investor Mark Broxmeyer and Memphis investment banker Brian L. Saulsberry. Stan Kasten, a longtime sports exec, also is known to be speaking with ownership groups as well as exploring his own bid.

Whoever lands the team—which industry observers predict could command \$300 million—will have to have more than buckets of money. The winners also must

have the political muscle to push through plans for a \$440 million ballpark paid for by D.C. tax dollars, which will need approval from a skeptical City Council. Most important, the new owners will need to have the confidence—and perhaps friendship—of Baseball Commissioner Bud Selig. “Who’s on your team matters a lot,” says John Moag, whose Baltimore firm brokers sports-team sales.

Even if the massive stadium-funding plan passes, the new owners will still have to beg for patience. The first pitch in their park won’t be tossed until 2008. For three years, at least, fans will be rooting for the Washington Whatever’s at tired RFK Stadium, which hasn’t seen a regular-season game

since the Senators skipped town in 1971. Randy Vataha of Boston-based Gamplan LLC, which handles franchise sales, says that “the first years will be very trying” and Washington insiders who understand the business and political communities will have a big advantage.

THE BUD FACTOR

IF COMMUNITY TIES will be helpful winning the club, a tight link to Selig could be key. “I don’t think anything more important,” says former Baseball Commissioner Fay Vincent, sometime sharp critic of Selig.

Selig has rewarded friends before. In 2002 the commish looked past a \$750 million offer for the Boston Red Sox from Cablevision Systems Chairman Charles F. Dolan. Instead, MLB accepted a \$660 million bid for the Red Sox from a group led by three league alums, including former Florida Marlins owner John Henry and former Baltimore Orioles and San Diego Padres President Larry Lucchino. The new owners have since turned the team into an American League power and one of the sport’s top revenue-generating franchises, justifying the commish’s decision.

In a Washington move, Selig would be looking for an ally who can keep the stadium project on schedule and help mend fences with Baltimore owner Peter G. Angelos, a bitter foe of relocating the Expos to the Orioles’ backyard. As part of a settlement with the Birds, the new owners could wind up as Angelos’ partners in a regional sports network.

As with all else in Washington, clout will count. A former investor in the Rangers—with George W. Bush—Malek has baseball connections; Selig, too, is friends with Bush. Broxmeyer is a “pioneer” who raised over \$100,000 for the Prez. Kasten, who ran the Ted Turner/Time Warner sports empire in Atlanta and oversaw construction of the new ballpark, is an intriguing Friend of Bud. He’s mum about his plans but until July was leading the bid to move the Expos to the New Jersey Meadowlands, say industry sources. “Kasten would be formidable,” predicts Vincent. But the game is just beginning. And there are nine long innings ahead.

—By Mark Hyman

THE STAT

\$300 million

The ballpark number the Expos would fetch (stadium not included)



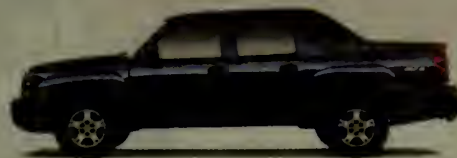
BLASTER FROM THE PAST Senator Frank Howard in 1970



Chevy Colorado



Cadillac Escalade



Chevy Avalanche



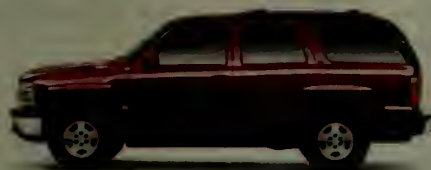
Buick Rainier



GMC Envoy XUV



Saturn VUE



Chevy Tahoe



HUMMER H2



GMC Sierra

it's Truck-tober



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EDITED BY MONICA GAGNIER

HEADLINER

GEORGE SOROS



ALL IN THE FAMILY

And the sons also rise. The scions of billionaire money manager and philanthropist George Soros have taken key senior roles at the \$13 billion **Soros Fund Management**. Jonathan, 34, is now co-deputy chairman of the New York firm, while Robert, 41, is chief investment officer.

The moves are part of a restructuring that began two years ago when the elder Soros, 74, brought in Goldman, Sachs vet Mark Schwartz as CEO. The new structure will allow the Soros brothers to focus on the core hedge-fund business, including the flagship **Quantum Endowment Fund**, which beat its benchmark in the past three years: 6.9% annual average returns, vs. 6.3%. An Oct. 4 memo to Soros fund shareholders says two investment management teams will be spun off as independent firms—real estate and credit. Efforts are also under way to spin off the private-equity unit.

With his sons in leadership positions, George Soros can focus on his latest job: getting George Bush out of the White House.

—Mara Der Hovanesian

SHOTS IN THE DARK

The flu season just got a lot more worrisome. On Oct. 5, British regulators shut down Chiron's Liverpool flu vaccine plant for three months before it could deliver any vaccines because of concerns over microbial contamination. Chiron is one of two major suppliers for the U.S., so its woes mean a serious shortage of vaccine. Instead of having more than 100 million doses on hand, the U.S. will have just 54 million doses from the other maker, Aventis Pasteur, and another 1 million to 2 million doses of a newer vaccine from MedImmune. The Centers for Disease Control & Prevention immediately recommended that flu vaccines be rationed, with available supplies being reserved for people at higher risk, such as children, seniors, pregnant women, health-care workers, and those with existing medical conditions.

FANNIE: A PEEK AT PAY STUBS



The battle over Fannie Mae got personal on Oct. 6, as a key Fannie critic released figures detailing the mortgage giant's pay packages. Fannie's top 22 execs collected \$71 million in 2002, House Financial Services subcommittee

Chairman Richard H. Baker (R-La.) disclosed. Fannie has fought for a year to keep those figures sealed. At a packed hearing, Fannie CEO Franklin Raines strongly disputed charges that Fannie manipulated expenses to ensure executive bonuses or violated other accounting standards. But Armando Falcon Jr., director of the Office of Federal Housing Enterprise Oversight, charged: "Fannie Mae understood the rules and simply chose not to follow them." Democrats, wary of undermining Fannie's ability to promote low-income housing, cautioned against any rush to beef up regulation, while GOP critics of Fannie decried its alleged accounting mishaps.

A RULING ON SUBSIDIES?

Boeing and Airbus finally will get their day in court. After years of rhetoric, the U.S. Trade Representative took the first step Wednesday and filed a World Trade Organization case against the European Union for giving billions of dollars in "unfair" subsidies to Airbus. The EU responded quickly with its own counterclaim, alleging that Boeing has received about \$23 billion in subsidies from the U.S. government. The good news is that both governments will have to disclose the subsidies received by Boeing and Airbus, and a WTO panel could finally settle this long-running dispute.

THE BUG GETS A LUBE JOB

Former DaimlerChrysler Chief Operating Officer Wolfgang Bernhard is tackling a new turnaround

job: fixing a sputtering Volkswagen. However, his assignment at VW may prove tougher than his three-year stint at Chrysler. VW suffers from product blunders, overcapacity, and high labor costs. Bernhard left DaimlerChrysler in April after a clash with boss Jürgen Schrempp over investment in Mitsubishi.

ET CETERA...

» **United Airlines** will cut domestic flights as it tries to leave bankruptcy.

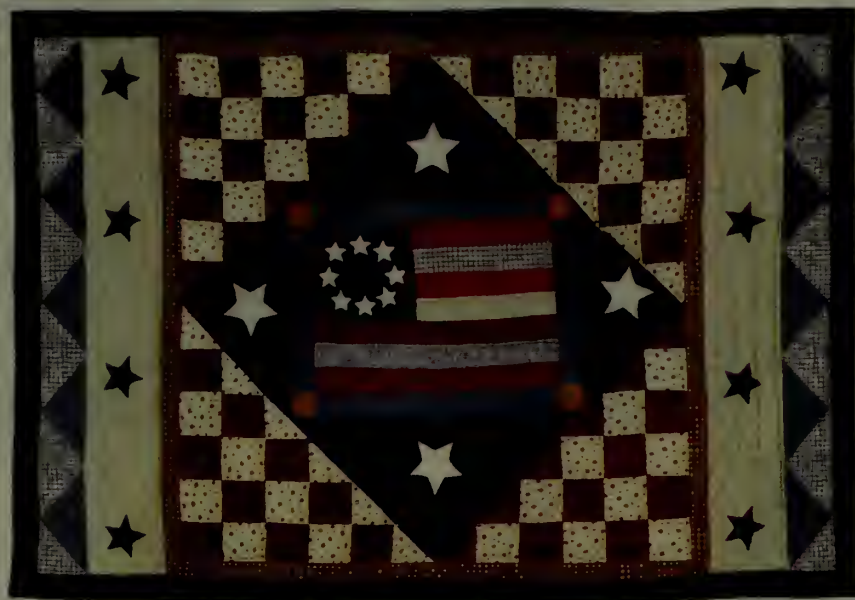
» **Krispy Kreme Doughnuts** named two directors to lead a review of accounting issues.

» **Deejay Howard Stern** will join **Sirius Satellite Radio** in January, 2006.

CLOSING BELL

Is the housing market cooling down? That's what investors feared when **Pulte Homes** cut its earnings forecast, citing lower-than-expected sales in Las Vegas. The homebuilder's stock fell 6.9% on Oct. 5, to \$52.45, though it recovered \$1.03 the next day.





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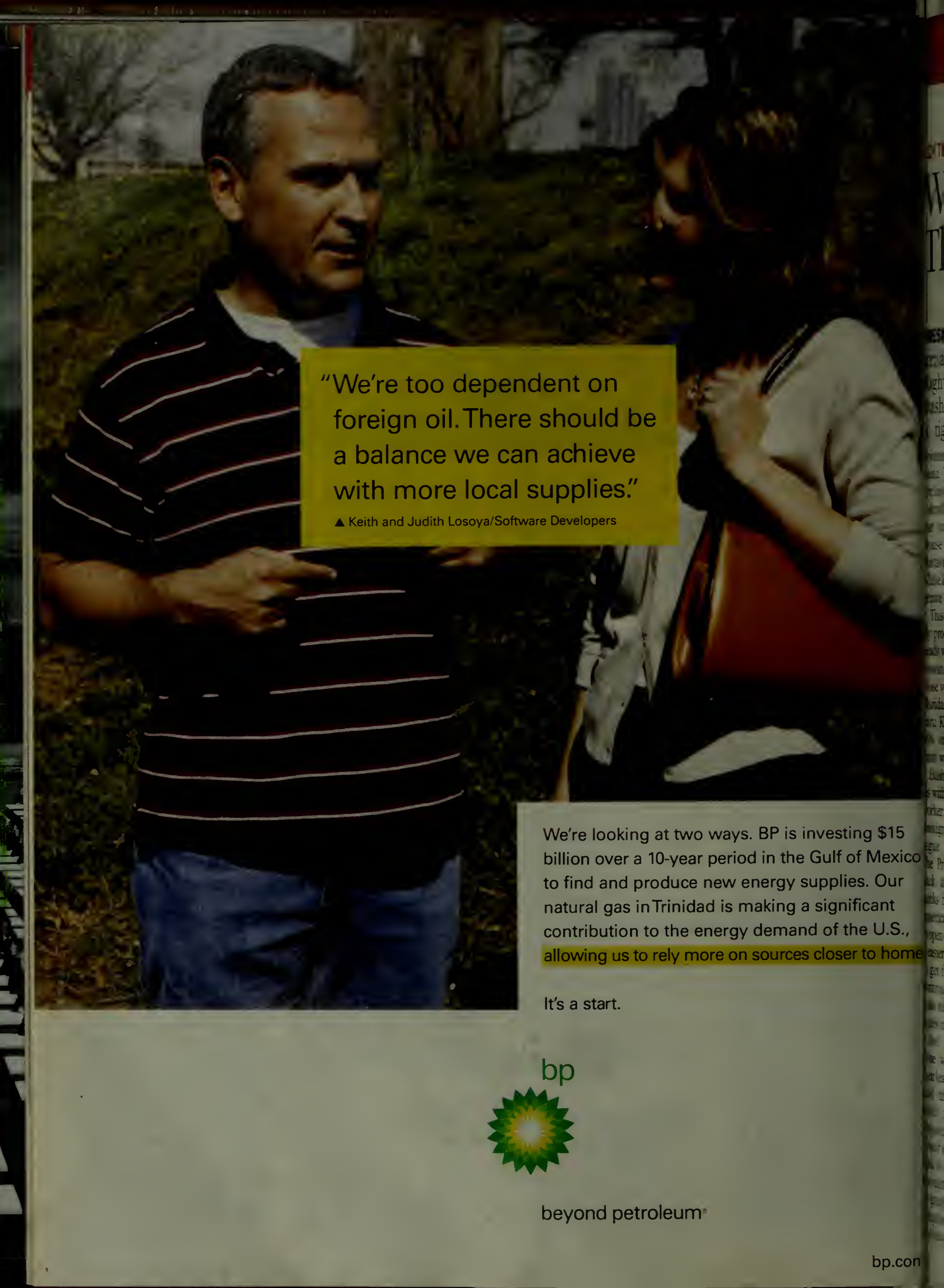
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EDITED BY LEE WALCZAK

Why Bush Isn't Moving The Needle With Latinos

PRESIDENT BUSH HAS BEEN TREADING a fine line on immigration, alternately sending a welcoming message while paying heed to the right's concerns about America's porous borders. But on Oct. 1, Bush aides looked at House GOP-backed legislation that sought to tighten immigration controls while implementing the 9/11

Commission's security findings—and said *asta*. The White House urged conservative lawmakers to strip out measures—like federal standards for drivers' licenses—that could antagonize Hispanic voters. House GOP leaders, pursuing their own election agenda, demurred—but the White House is likely to win in the House-nate conference.

This is not the first time that the ostensibly pro-immigration President has butted heads with hard-liners. With Latinos a fast-growing part of the electorate, Bush needs those votes to prevail in toss-up states like Florida, New Mexico, and Nevada. Political guru Karl Rove wants to improve on the 2% of the Hispanic vote Bush won in 2000.

Bush has wooed Hispanics with his call for a guest-worker program that offers migrants a path—albeit a vague one—to citizenship. The Prez also helped beat back a drive to bar U.S. banks from accepting Latin American national ID cards to open an account. He made it easier for legal immigrants to get food stamps. And he continues to pitch strong appeals to religion and family values in Hispanic areas.

But immigration is one issue where conservatives won't follow their leader. Many GOP traditionalists contend that granting illegals citizenship would reward “un-American” behavior. Opposition to the guest-worker idea was so heated that the White House never sent a plan to the Hill. “Within the party, and throughout the country, people don't want to grant amnesty to people who came here illegally,” says Representative Dana Rohrabacher (R-Calif.).

The stillborn Bush reform has stirred animosity among Latino leaders—and led liberal-leaning activists to insist that the President is all *sombrero*, no cattle. “The Administration has pretended to be Latinos' friend,” says Michele Waslin, an analyst at the National Council of La Raza. “Their actions speak louder than words.”

A Dream on Hold

LATINO ACTIVISTS are frustrated that the White House hasn't backed the Dream Act, promoted by Senate Judiciary Committee Chairman Orrin Hatch (R-Utah). It would offer legal status to high school graduates who came to the U.S. as children. The

Bushies also set off an uproar when they required border hospitals seeking federal aid to quiz patients about their immigration status. After Hispanic and hospital groups howled, the Administration said it would try to get the data without questioning patients.

At Hispanic stops on the campaign trail, Bush still struts his Texas *machismo*

and laces his appeals with a smattering of Spanish. But with mixed messages from GOP ranks, Rove's dream of boosting the Prez's share of the Hispanic vote may be dimming. A

Sept. 27-29 poll by the nonpartisan William C. Velasquez Institute shows Bush with 36% of Latino support in four Southwestern states, a figure WCVI President Antonio Gonzalez predicts will shrink as Democrats spread the word about legislation that has foundered on Bush's watch. With a pro-Dem registration tide sweeping those Blue States, any erosion in Bush's standing with Latinos could prove costly. ■

—By Alexandra Starr



FIRST NEPHEW
Half-Hispanic
George P. Bush
stumps for the Unc

CAPITAL WRAPUP

THE GROWING IRRELEVANCE OF RALPH

EVEN AS HE LANDS on more state ballots, **Ralph Nader** is watching his support collapse. Just 1% of Americans say they are certain to vote for Nader for President, according to an Oct. 1-3 Pew Research Center poll. Unlike 2000, he's not drawing liberal votes from the Democrats. His remaining supporters are independents, 2% of whom still like Ralph.

A SMALL GIFT FROM THE SEC

REPUBLICANS WHO have bit their tongues through the Securities & Exchange Commission's rule-writing spree may finally have something to cheer. **Chairman William H. Donaldson** plans to loosen rules governing the “quiet period” that companies must maintain prior to an IPO. It's a rare case of deregulation from an agency that's been in overdrive for two years, with Donaldson's campaign to crack down on mutual funds and hedge funds coming right after the 2002 Sarbanes-Oxley Act.

WHERE MUSLIMS AND JEWS MEET

PRESIDENT BUSH has managed to unite Jews and Muslims—but not with a peace plan. Recent polls find that both groups strongly favor **John Kerry** for President. A Zogby International Poll reports that 68% of Muslims back Kerry, vs. 7% for **President Bush** and 11% for Lebanese-American Nader. That's a huge shift from four years ago, when Bush led Al Gore among Muslims by 11 percentage points. An American Jewish Committee Poll shows Bush trailing Kerry 69%-24% among Jewish voters, though that is still better than the 19% he got in 2000.



TATA MOTORS Car output is up, and so is productivity

INDIA

THE FACTORIES ARE HUMMING

Indian manufacturing is surprisingly strong—and fueling an export boom

ASK ANY GLOBAL INVESTORS for their quick take on India, and you'll get the usual answer: Software and outsourcing are all that count. Manufacturing—hobbled by strict labor laws, red tape, and a lack of critical mass—is just not a field where India can excel.

That's the conventional wisdom. But contrary to expectations, Indian manufacturing is proving surprisingly robust. So robust, in fact, that India's gross domestic product grew a healthy 7.4% in the second quarter, beating expectations by a long shot. The consensus is that manufacturing—now growing almost as fast as India's vital services sector—is what provided the extra kick. India's 25% surge in exports got a boost from manufacturing

as well. Foreign and domestic investors have bid up shares of corporations such as tractor maker Mahindra & Mahindra and auto-parts biggie Bharat Forge.

India certainly has a ways to go before it turns into the next China, which has accumulated hundreds of billions in foreign investment in manufacturing during the past decade. Indian roads and ports still don't hold a candle to China's, and the mass production base already installed in

China is still building up in India. "Global [companies] want to source \$50 million to \$100 million at a time, but often in India, that's the size of the entire company," says Nagi Palle, a principal consultant A.T. Kearney in India, adding that India doesn't yet have the scale to be a world-class manufacturer.

Yet powerful trends are giving manufacturing a lift. The ruling Congress Party coalition, under Prime Minister Manmohan Singh, wants to add billions more to the \$177 billion in infrastructure spending already planned. Big-ticket projects in

clude a \$14.5 billion cross-country highway system, as well as the expansion of ports, airports, and railroads. Even India's maligned power sector is turning. About 12 new private power projects worth \$2.6 billion have been approved by the government.

HOT STEEL

AND THE PRIVATE sector? Indian companies are planning about \$105 billion worth of capital expenditures. Tata Steel, for instance, will spend \$3.2 billion to make overseas acquisitions and expand capacity in India from 3 million tons to 7.5 million. In all, about \$440 billion will be spent in public and private projects over the next five years, according to Bombay researcher Projects Today. "The kind of investment we're seeing now, we haven't seen for years," says Arinda Bhattacharya, director and expert in manufacturing, Boston Consulting Group, India.

Companies such as Tata, Birla, Steris, and Gujarat Ambuja are rushing to meet the demand of ever-higher exports of steel to China and cement to the Middle East and Asia. But it's not just commodities that are flourishing. A hefty part of the capital expansion is going into auto components, machine engineering, textiles, and pharmaceuticals. According to Projects Today, investment in these sectors grew 8.2% this year, compared with a decline of 3.6% last year. These industries have spent the past decade restructuring, battling with government to implement better economic policies, and preparing for global competition. The result is

India's Industrial Boom

Growth in Manufacturing	Gain in Auto-Parts Exports	Increase in Car Production
8%*	30%**	30%***

* June quarter; ** 12 months through March; *** 12 months through August. Data: Ministry of Industry, India; Merrill Lynch

seen a surge in productivity for the best companies. Take Tata Motors: In 1999, it made 129,000 cars with 35,000 workers. Today it makes more than 300,000—with 10% fewer factory hands.

EXPORTS TO EUROPE

DEMAND IS BRISK, too: Domestic car sales have soared by 25% in the past year, to more than 1 million vehicles, while parts exported worldwide have seen 30% growth. Tata and Mahindra are exporting, while Hyundai Motor Co. is using India as a manufacturing and export base for its compacts to Europe. Toyota Motor Co. has just started exporting 150,000 transmissions to other Toyota plants in Southeast Asia. Indian forging and castings companies such as Bharat Forge Ltd. are exporting 40% of production to clients like DaimlerChrysler and Cummins Engine Co.

Indian executives hope they'll get even bigger boosts from special incentives the government is providing. India's first private China-style special economic zone (SEZ) has started up in Madras, and the 1,500-acre SEZ—which is free from strangulating labor and tax laws—has attracted the dy-

amic exporters: auto parts, apparel, and so tech.

Other companies are launching complex projects without the help of special incentives. In Hyderabad, a South Korean company will soon build India's first semiconductor plant. Korea's LG is investing \$150 million in a new factory to make and export televisions and refrigerators. Finland's Elcoteq Network, which makes cell phones for companies such as Nokia, will begin assembling handsets in Bangalore this year, while India's high-technology skills have attracted Ericsson to manufacture radio transmitters and receivers for cell phones in Jaipur. India will move in the opposite direction from China, says Anand Mahindra, managing director of tractor maker Mahindra & Mahindra. "We will design and create value in products first; then the factories will follow. India will move from niche to mass manufacturing," he says. Not the textbook route, but with luck it's the one that will work for India. ■

—By Manjeet Kripalani in Bombay

BOURSES

Singh's Deft Maneuvering Is Bringing Back Investors

Investors have decided they like Indian Prime Minister Manmohan Singh. That's a major switch: Four months ago the upset victory of Singh's Congress Party drove India's bourses down 20% in a matter of days. The fear was that reform would stall as Singh proved himself both easily manipulated by Sonia Gandhi, the Congress Party president, and cowed by that party's left-wing allies.

Yet now stockpickers both foreign and domestic are back, driving the market up 26% since mid-May. "People are surprised by how much more market-friendly than expected the coalition is," says Rajeev Malik, senior Asia economist for J.P. Morgan in Singapore.

Singh certainly has his problems, and this being India, some of them are sizable. The communist members of the Congress coalition are obstreperously opposed to too many market-friendly measures. "With allies like the Left, who needs an opposition?" asks Surjit S. Bhalla, a respected economist and fund manager at Oxus Investments in New Delhi. Then there's the matter of local and state finances: Congress is rushing to make good on its campaign pledges by diverting funds to the countryside, but it's not doing enough to help the fragile fiscal positions of cities such as Bombay. Singh says that will change. Despite the assurances, in mid-October's local elections, some urban voters might deliver a sharp rebuke to Congress, and thus weaken its overall position in New Delhi. Budget politics could also get rough if a late monsoon damages farm incomes.

Hairy problems indeed. Yet investors see a technocrat who has finessed his way out of a number of situations. Rajen Mariwala, who runs Hindustan Polyamides, a chemicals business in Bombay, especially appreciates Singh's deft handling of the Left: "Dr. Singh gives us great hope that the right kind of people are sitting at the top." With his team of Finance Minister P. Chidambaram and economic adviser Montek Singh Ahluwalia, Singh has placated the stock market by abolishing the tax on long-term

capital gains and reducing the levy on short-term gains. By next April, India's 29 states will rationalize their complex, corruption-laden tax structure by switching to the value-added tax. The move is expected to boost the tax base and hike revenues by 50%, according to New Delhi's Center for Policy Alternatives.

Singh has also softened the impact of high global commodity prices by cutting import tariffs on oil, petrochemicals, and steel, forgoing \$1 billion in government revenues but preventing a public outcry. And the Prime Minister has moved to curb the profligate ways of India's states by tying federal funding to fiscal responsibility. Abroad, Singh has secured



URBAN BLUES Singh has to reassure the cities

a crucial gas-pipeline deal with Pakistan—evidence that the peace process between the two countries is gathering momentum.

The question is, how will Singh do in his second act—especially vis-à-vis the communists? So far he has managed to "keep talking left but walking right," says Manish Chokhani, director of Enam Securities in Bombay. The hope is Singh will constrain their protests. "These differences will be kept within the limits of prudence," Singh told reporters on Oct. 6. In late September, for example, the communists squawked when Singh tried to name McKinsey and World Bank consultants to a special advisory committee. In response, Singh scrapped the panel. Why was that clever? Because the communists, too, suddenly lost their places on the committee. Singh has a tough job to do. But to date he's shown a lot of savvy.

—By Manjeet Kripalani in Bombay

JAPAN

HOW SHARP STAYS ON THE CUTTING EDGE

The leader in flat-panel TVs also banks on cell phones, solar power, and white goods

SHARP CORP.'S TAKUJI Okawara has one of the coolest jobs at one of Japan's coolest companies. Okawara, 58, is a top executive at the Osaka consumer-electronics company that has become the world's leading producer of thin-screen TVs made with liquid crystal displays (LCDs). His job: As technology becomes more commoditized, make sure that Sharp always stands out from the crowd. "We need to create something new, something different," Okawara explains. "We can stay away from making commodity products with a combination of high technology and high-end design."

How cutting edge is Sharp? At CEATEC Japan, a big consumer-electronics show near Tokyo in early October, Sharp's newest products were on full display: The company showed a prototype of a monster 65-inch LCD TV—the largest made. Then there were the design touches. Some of Sharp's big-screen LCD models were framed in superglossy Japanese lacquered red and black wood. And just to rub in how dominant Sharp is these days, on Oct. 4, the day before the show started, the company announced it expects earnings for the six months ended Sept. 30 to be \$351 million, up 40% from a year ago, on sales of \$11.3 billion. "We are convinced that LCD TVs will be the mainstream TV for the world market," says President Katsuhiko Machida.

VIRUS-ZAPPING ACS

SHARP, IN MANY ways, is the company that Sony wishes it still was: tops in a key hardware sector and raking in the money. The company's global share in LCD TVs is 35%. And the TV business has made the company Japan's most profitable electronics maker over the the last five years,



according to a recent Lehman Brothers Inc. report. And with \$3.3 billion in cash on hand, Sharp can easily invest in making ever bigger LCD panels, the key component of its TVs.

Where does Sharp go from here? Deeper into LCD TVs, certainly. Lehman

projects the company will sell 3 million sets this year, double last year's sales. big priority is to bring down costs, make the TVs more mainstream, and combat competition from Taiwan and China. Those me-too rivals are already doing damage. Riddhi Patel, an analyst with California market research firm iSup Corp., notes that Sharp's 35% global share in LCD TVs this year is down from 50% last year.

Machida's strategy is to keep producing innovative TVs while beefing up business in related fields. One target is mobile phones, where expertise in LCDs offers an advantage. "They know how to make the best displays," says Gerhard Fasol, CEO of Eurotechnology Japan, a Tokyo consulting firm.

"The screen is fantastic," he says. While Sharp had hand sales of only \$3 billion last year—compared with \$1 billion for Motorola Inc.—its sales were up 37%.

The two other areas where Machida wants to flex his muscles are appliances and solar panels. In white goods, sales of such items as refrigerators, air conditioners, and ovens account for 9% of Sharp's revenues, but contribute almost no profit. Machida wants to fix that with a technology upgrade. That means air conditioners that can zap viruses in the air and ovens that actually leech the fat out of meat.

Machida & Co. are especially excited about the potential for their solar business, which could bring in \$900 million in revenue this year. Sharp has been making solar cells since 1963, and controls 25% of the business worldwide.

CEATEC, the company demonstrated a new array of solar panel skylights for commercial use that transform sunlight into electricity during the day, and then use the electricity to power light-emitting diodes that illuminate a room at night.

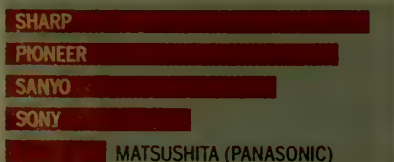
Sharp's plans to hedge its bets against an LCD glut are no sure thing, of course. For instance, Machida's plans to upgrade the white-goods division are unimpressive, but Sharp remains No. 5 in the business in Japan. Obstacles? Yes. Then again, that long-ago bet on LCDs was no sure thing, either. ■

—By Bruce Einhorn in Osaka
with David Rocks in Tokyo

PROFIT MACHINE

Sharp's dominance in LCD panels and TVs has given it the best margins in Japanese consumer electronics

PERCENT



NOTE: FIVE-YEAR AVERAGE OPERATING PROFIT MARGINS
Data: Lehman Brothers

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IRAR070160



RUSSIA

NOVATEK: A GAS GIANT YOU'VE NEVER HEARD OF

The reserve-rich newcomer just partnered with Total. The goal: Get even bigger fast

IT'S A COMPANY FEW PEOPLE have heard of. Little is known about its owners or its origins. It isn't listed on any stock exchange and only recently began publicizing itself to investors. Oh, one more thing: It's worth around \$4 billion.

Meet Novatek, a Russian gas producer that has just clinched one of the biggest foreign-investment deals in Russian history. On Sept. 22, France's Total announced plans to buy 25% plus one share of Novatek. According to market sources, Total will pay \$1 billion. Not a bad price for a company that was only founded 10 years ago, began significant production two years ago, and is not exactly a household name even in Russia. But the price may well be worth it: "Novatek is an excellent platform for further expansion in Russia," says Kaha Kiknavelidze, oil and gas analyst at Moscow brokerage Troika Dialog.

Put Russia and natural gas together in a sentence, and most people think of Gazprom, the world's biggest gas producer. But independents such as Novatek pump out an ever-growing share. True, Novatek, with just 3% of Russia's gas output, is a mere fledgling compared with Gazprom. But while Gazprom managed

to boost its output by just 3.7% last year, Novatek's was up 59%, and it's on course for a 48% hike this year, to 13.5 billion cubic meters. Novatek is sitting on top of an estimated 1.5 trillion cubic meters of gas, with audited reserves of 864 billion cubic meters of gas and 956 million barrels of crude oil.

Who are these Novatek guys anyway,

Novatek

Russia's largest independent gas company

FOUNDED: 1994

CEO: Leonid V. Mikhelson

MAIN ASSETS: Yurkharovskoye, East Tarkosalinskoye, and Khancheykoye fields in northern Siberia

GAS RESERVES: 864 billion cubic meters

VALUATION: \$4 billion

OUTPUT*: 13.5 billion cubic meters**

REVENUES*: \$580 million

NET PROFIT*: \$110 million

*2003 **Net

Data: Novatek BusinessWeek

GASEOUS ASSETS
Novatek snagged Siberian reserves on the cheap

and how did they acquire so much gas? Unlike most of Russia's energy companies, Novatek

didn't pick up its lucrative acreage during the privatization free-for-all of the 1990s. It grew out of the Kuibishev Pipeline Construction Co. in Samara, which was privatized and sold to management in 1991. Novatek's mineral wealth came later when managers had the bright idea of diversifying into oil and gas extraction. "We didn't receive anything. Everything the company has was created during the last 10 years," says Leonid V. Mikhelson, Novatek's CEO and the former general director of the pipeline company. In 2003, Novatek reported net profits of \$110 million up from \$20 million the year before.

SAVVY MANAGEMENT

NOVATEK OWES MUCH of its growth to smart investments. In 1994, Mikhelson and his partners teamed up with a geological exploration company to prospect for gas in the far northern Yamal-Nenets region. Mikhelson's background in pipelines gave him useful contacts there, and Novatek bought exploration licenses in the mid-1990s at a fraction of what they would cost today. "He's a smart and tough manager who has taken advantage of all the opportunities given to him," says Andrei Gavryushenko, editor of *Do*, a Samara business weekly.

Pipeline access and regulated domestic prices are Novatek's biggest problems. Gazprom has no legal obligation to grant access to independent producers. Russians pay \$28 per thousand cubic meters for gas, compared with \$120 in western Europe, while independent producers are shut out of lucrative foreign markets by Gazprom's export monopoly. Even liberalization of this sector may create openings for independents, and Russia has promised to hike domestic gas prices to \$60. But reform has been glacial.

Novatek isn't waiting for the start of the gun. It aims to triple production of oil and gas condensate to 5.2 metric tons by 2006 and is investing heavily in refining. Those ambitious plans require lots of capital. That's why Novatek struck a deal with Total, and why it's looking to international capital markets as well. It also explains why Novatek is revising its low-profile approach. "We weren't interested in PR. We just got on with business," says Mikhelson. The question now is whether Novatek will continue to do as well in the limelight as it has done in the shadows of Siberia.

—By Jason Bush in Moscow

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COMMENTARY

BY JACK EWING

How Germany Inc. Is Loosening Up

It's ditching the old network of cross-shareholdings. That's good for investors

GERMANY'S HEIDELBERGER Druckmaschinen may be the world's leading maker of big printing presses, and Hochtief Germany's largest construction company, but what do these businesses have in common with RWE, Germany's No.1 electricity provider? Good question—and one Harry Roels couldn't answer when he took over as chief executive

of Essen-based RWE in early 2003. So Roels sold off RWE's 50% stake in Heidelberg and 56% position in Hochtief earlier this year, part of a selling spree worth \$6.5 billion. "Now management can concentrate on our core businesses" of electricity, gas, and water, says Roels.

The logic behind that strategy—why tie up capital in businesses that don't have anything to do with your main mission?—may seem obvious. But it escaped much of corporate Germany for years. Managers seemed to have a tough time letting go of Deutschland AG, or Germany Inc., the postwar system in which banks and corporations helped one another rebuild the economy through interlocking shareholdings. Big financial institutions such as Deutsche Bank and insurer Allianz Group owned pieces of almost every major company, including each other. They exerted influence over industrial conglomerates, which in turn were active in an array of unrelated businesses.

This cozy network of cross-shareholdings became a drag on the nation's competitiveness at least a decade ago. But even after the German government abolished the capital-gains tax on corporate disposals in 2001, companies moved hesitantly—

raising suspicions that managers were reluctant to cede power they enjoyed over swaths of the German economy.

Turns out they were just waiting to get a good price. In past two years Germany's major corporations have been focusing on what they do best and unloading the rest. The rest of the rope has been busy unwinding its cross-shareholdings, too.

That's positive not only for corporate balance sheets but for the whole economy. Companies operate more efficiently when managers can concentrate on their strengths. "Clearly there is an effect on management time," says RWE's Roels. Some economists say that corporate restructuring has helped boost German productivity, which Commerzbank expects to surge 4.8% this year, after growing 2.9% in 2003.

Another encouraging development is the rise of private equity. German bosses used to regard private-equity firms as creatures to be avoided. But lately managers have come to see them for what they often are: a catalyst for restructuring. Private equity is especially good at helping companies unload businesses too small to spin off via

public offerings.

Of course, plenty remain to be sold off. For instance, Deutsche Bank still owns a huge 10% chunk of auto maker DaimlerChrysler. Deutsche CEO Jürgen Ackermann says the bank's long-term plan is to focus on banking, but he won't commit to a time frame for untangling the bank's remaining industrial stakes. Troubled DaimlerChrysler, though, is nothing but a distraction for Deutsche as it focuses on boosting its own business. Ackermann ought to get rid of the bank's other industrial stakes quickly.

Moreover, healthy competition is still stymied by a stubborn network of personal relationships even as companies sell their holdings. Corporate servers, though, say the new generation of executives—managers like Siemens CEO-designate Klaus Kleinfeld—are less close and more interested in the bottom line. Look for the unwinding to continue. ■

HEIDELBERGER
RWE sold its stake
in the pressmaker



Unwinding

Germany's big financial institutions have drastically reduced their shares in Germany Inc., but they still wield influence

FINANCIAL INSTITUTION	SOLD OFF OR CUT STAKE IN	BUT STILL HOLDS
DEUTSCHE BANK	Allianz INSURANCE Continental TIRES HeidelbergCement	DaimlerChrysler AUTOS Linde INDUSTRIAL GASES
ALLIANZ	BMW AUTOS BASF CHEMICALS Beiersdorf COSMETICS	Munich RE Lufthansa AIRLINE
WESTDEUTSCHE LANDESBANK	Landesbank Rheinland-Pfalz BANK Klöckner & Co. STEEL	TUI TRAVEL RWE ENERGY

Data: Deutsche Bank, Allianz, WestLB, BusinessWeek



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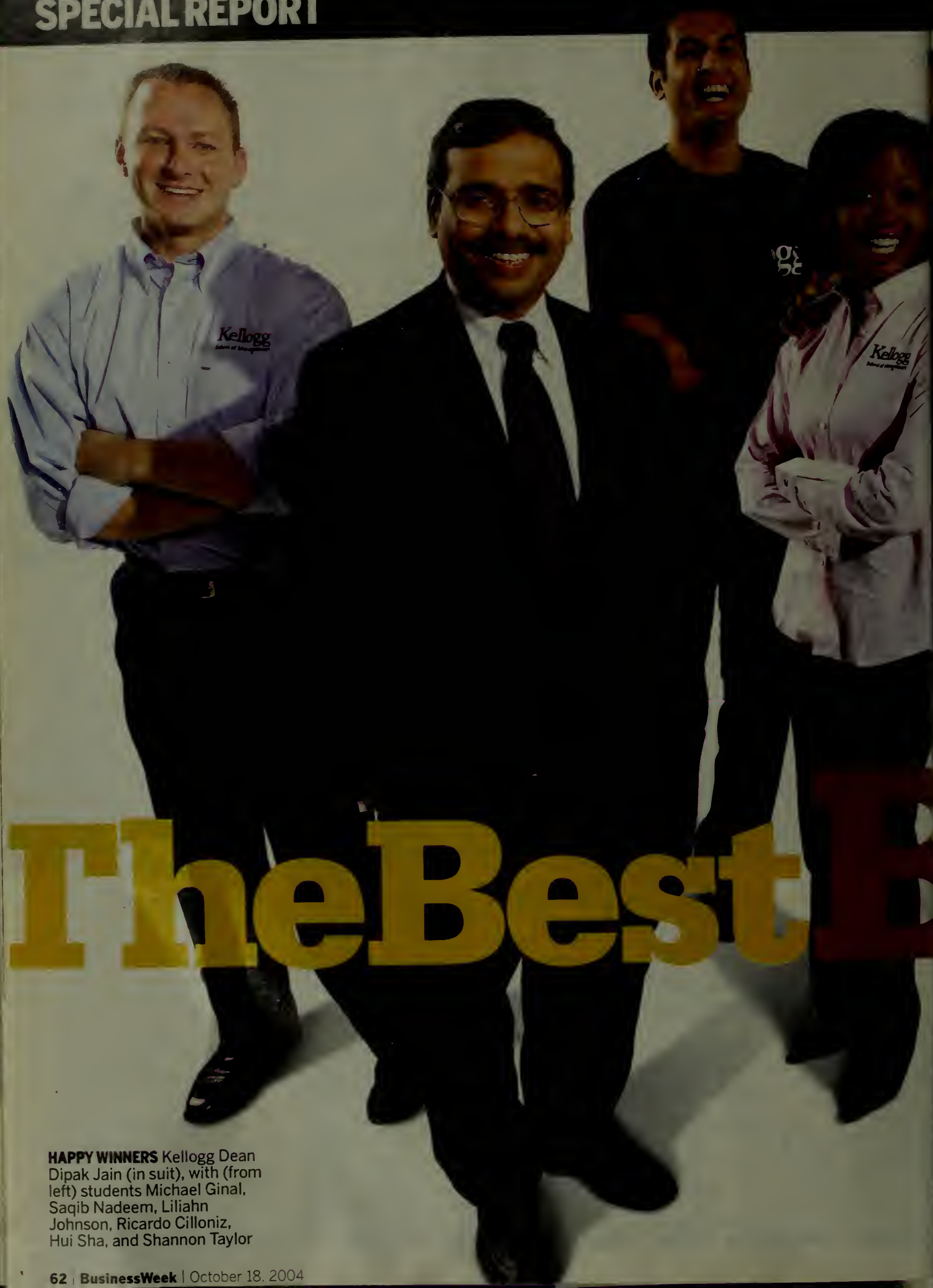
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Airlines

CSA
Czech Airlines

Delta

KOREAN AIR

nwa
NORTHWEST AIRLINES



HAPPY WINNERS Kellogg Dean Dipak Jain (in suit), with (from left) students Michael Ginal, Saqib Nadeem, Liliahn Johnson, Ricardo Cilloniz, Hui Sha, and Shannon Taylor



Schools known for tougher academic standards gained ground—with students and recruiters

BY JENNIFER MERRITT

MIDWAY THROUGH HIS MBA PROGRAM, ANDY Brown had a big decision to make. His career choices—to start his own small private equity firm with a partner, or join a prestigious firm and learn at the feet of the masters—were enviable for any soon-to-be graduate. But Brown, a student at Northwestern University's Kellogg School of Management, was torn. So he did what he'd done dozens of times before. He turned to Professor Larry Fox.

At Fox's home north of Kellogg's Evanston (Ill.) campus, the two spent hours sipping tea and sorting through Brown's options. Fox, 61, who led an elective class on private equity in 2003, helped Brown hash out the pros and cons of each path and examine his long-term goals. Fox shared his own experiences at similar career crossroads. When Brown left, he had the names of three high-level executives Fox knew personally to call for more brainstorming. For the next year, the two continued to dissect Brown's choices by phone—by then, Fox had retired to California.

It might seem an unusual relationship, but for Brown, 29, it was not uncommon. Other professors

Schools

had been equally generous: One was a sounding board for Brown's business ideas, and another helped Brown raise money for a Kellogg business plan competition. "One of the main reasons I chose Kellogg was for its extremely accessible faculty," says Brown, who ultimately chose to join a Houston-based private equity firm. Kellogg's academic rigor, responsive administration, and closeknit community were equally appealing.

The balance between an in-depth academic experience and a welcoming culture is what once again put Kellogg at the top of *BusinessWeek's* 2004 biennial survey of the world's best business schools. In a year when MBA students rebelled

BRAD TRENT

THE BEST B-SCHOOLS

against academic corner-cutting and sloppy ethics, Kellogg's achievement represents a high-water mark of sorts. With five No. 1 rankings to its credit, Kellogg now has more than the University of Pennsylvania's Wharton School, the only other school to win the top spot since *BusinessWeek* began ranking B-schools in 1988.

Clearly, Kellogg's is a formula that works. But it wasn't the

only way to ascend to the top. Downtown rival University of Chicago Graduate School of Business, with its cerebral environment and research-oriented bearing, stands in stark contrast to Kellogg—and it landed at No. 2 for the third time since the rankings began. Yet it may be what Chicago has in common with Kellogg that made the difference this year: a mix of pure scholarship and can-do culture that permeated

The Best B-Schools of 2004

Graduates in the Class of 2004 had reason to smile. After three years of gloom in the job market, things were looking up for grads of the Top 30 schools. More than 89% had job offers three months after graduation, and total compensation was up about 26%, to \$136,569.

At many schools, enrollment of women has reached an all-time high—and so have tuition and fees, with increases in the double digits at some schools. The highest? Harvard at \$39,100. The best bargain? Indiana at \$24,201. Selectivity decreased for the class of 2004 due to fewer applicants at most schools.

The letter grades (at far right) are based on graduate and corporate recruiter surveys from the 70 U.S. schools surveyed and the 223 companies that responded. The top 20% in each category earned As. The next 25% got Bs, the next 35% got Cs, and the bottom 20% got Ds. Schools with too few recruiter responses received an NA.

See page 72 for details on how we calculated the data.

2004 RANK	SCHOOL	2002 RANK	CORP. POLL	GRAD. POLL	INTELLECT. CAPITAL	ANNUAL TUITION*	APPLICANTS ACCEPTED	WOMEN	ENROLLMENT INTL.
1.	Northwestern (Kellogg)	1	3	2	20	\$36,370	23%	30%	31
2.	Chicago	2	1	5	14	34,400	NR†	30	29
3.	Pennsylvania (Wharton)	5	5	3	6	35,203	16	34	33
4.	Stanford	4	7	1	3	37,998	10	36	32
5.	Harvard	3	2	11	7	39,100	13	35	33
6.	Michigan (Ross)	8	4	9	15	32,688	35	26	29
7.	Cornell (Johnson)	11	8	8	5	35,660	36	27	28
8.	Columbia	7	6	15	4	36,295	15	33	28
9.	MIT (Sloan)	6	14	4	2	37,050	20	25	35
10.	Dartmouth (Tuck)	10	11	6	9	38,857	25	30	29
11.	Duke (Fuqua)	9	12	12	10	36,399	37	33	33
12.	Virginia (Darden)	12	13	7	34	35,200	38	27	26
13.	NYU (Stern)	15	10	14	25	35,760	22	38	31
14.	UCLA (Anderson)	16	21	10	1	26,691	25	30	24
15.	Carnegie Mellon (Tepper)	19	15	19	11	37,000	28	23	30
16.	UNC (Kenan Flagler)	18	17	17	8	33,500	47	29	27
17.	UC Berkeley (Haas)	13	19	13	23	33,758	17	27	34
18.	Indiana (Kelley)	20	18	18	43	24,201	33	26	30
19.	Texas (McCombs)	21	23	22	26	30,116	43	25	24
20.	Emory (Goizueta)	22	27	20	12	32,468	37	23	30
21.	Purdue (Krannert)	26	20	28	17	26,988	44	19	35
22.	Yale	14	28	21	17	37,359	25	32	29
23.	Washington U. (Olin)	24	38	16	16	34,285	54	23	35
24.	Notre Dame (Mendoza)	29	9	35	33	30,530	49	23	28
25.	Georgetown (McDonough)	30	24	26	38	32,976	41	32	37
26.	Babson (Olin)	NA	16	32	44	29,900	59	27	30
27.	USC (Marshall)	17	29	23	40	34,692	36	31	22
28.	Maryland (Smith)	25	37	24	21	30,216	38	34	34
29.	Rochester (Simon)	27	39	25	18	34,767	37	23	42
30.	Vanderbilt (Owen)	28	36	27	21	32,790	68	25	24

the ranks of administration, faculty, students, even recruiters. Indeed, Chicago's grads were hands-down favorites in our survey of companies that hire MBAs. More than just a factory for churning out economic whiz kids, the school's capacity for shaping students' thinking was at the top of recruiters' minds. "Everything is grounded in theory and analytics," says Blaine Barnett, a 2004 grad now working for high-end

recreational product maker Brunswick Corp. "In every class it was, 'prove it to me,' 'show it to me,' 'tell me why you think that,' 'give me the data.' It's a way of thinking, a way of conceptualizing the problem."

Chicago's penchant for critical thinking has a long and storied history. But enthusiasm among students, and even faculty, is a newer phenomenon, ushered in by alum and now-dean

SALARY PAY** POST-MBA THOUSANDS	% GRADS W/OFFER BY GRADUATION	AVG. WORK EXPERIENCE MONTHS	DESCRIPTIONS	RECRUITER GRADES			MBA GRADES	
				COMMUNI- CATION	TEAM- WORK	ANALYTIC SKILLS	TEACHING QUALITY	CAREER SERVICES
\$125.0	85%	62	Grads commend Kellogg's teamwork-oriented culture. Recruiters say the innovative curriculum produces the best marketing and general management grads.	A	A	A	A	A
127.0	82	53	Ranks tops with recruiters for analytical skills and finance. Student raves across the board—from curriculum to career services—keep Chicago near the top.	A	B	A	A	A
144.0	86	72	Revamped career services and increased global presence gains school nine spots in grad poll. The perennial powerhouse still ranks tops with recruiters in all areas.	A	A	A	B	A
150.0	81	48	Grads maintain tech-savvy, entrepreneurial reputation with recruiters. Students deem their peers and the overall program top-notch.	A	A	A	A	A
147.5	94	53	Students still appreciate the high-powered network of alums but downgrade an unresponsive administration. Recruiters still give high marks overall.	A	A	A	A	A
115.0	85	62	Gets the most-improved award from recruiters who applaud grads' general management and operations skills. Students rate it tops in leadership training.	A	A	A	B	A
115.0	71	60	Sees a five-point jump in the corporate poll this year as recruiters take note of new curriculum. Grads compliment career services efforts and give high marks all around.	A	A	A	A	A
142.5	87	59	Recruiters look to Columbia for finance whizzes with a global perspective. Students like the diverse community but complain about teaching quality and cramped facilities.	A	A	A	C	A
128.0	91	64	Recruiters knocked MIT down three spots to No.9, but grads' support of the cutting-edge curriculum and faculty is unflinching, and faculty research is top-rate.	B	C	A	A	B
135.0	88	61	Grads enjoy close relationships with faculty and a close-knit campus community. Steadfast recruiters rely on Tuck's top-notch general management program.	A	A	B	A	A
118.0	79	68	Strong emphasis on leadership and teamwork rates high with students, but both grads and recruiters would like to see more global reach.	A	A	A	B	B
120.0	69	60	Students give high praise to Darden's faculty but long for a more diverse campus. Grads' teamwork and business ethics keep recruiters coming back.	A	A	B	A	B
130.0	80	59	Jumps two spots as grads credit improved teaching quality and a helpful career services office. Financial recruiting base remains solid.	B	B	A	A	A
127.0	78	56	Gets high marks for faculty research, but students rate profs low on the availability scale. Recruiters still come for general management experts.	C	B	B	B	A
110.0	77	52	Again takes No.1 grade with students for focus on technology and e-business but fails to place above average in other categories. Feeling among recruiters is mutual.	C	B	A	A	B
110.0	68	63	Although students say the administration is responsive, they want better teaching in core courses. Reputation in corporate world grows with a new dean.	B	A	B	B	B
131.0	78	67	Haas loses favor with grads and recruiters, bringing it down four spots. Students say faculty are less accessible but still rate the entrepreneurship program among the best.	B	B	B	B	B
103.0	67	59	Overall grad and corporate rankings inch upward. Core faculty earn an A+ from Kelley grads in a year when most MBAs grumble about poor teaching quality.	A	B	B	A	B
110.0	65	61	Dropped by a handful of recruiters since 2002. Grads express confidence in starting their own businesses with skills learned at McCombs.	A	A	B	B	B
107.0	74	58	Faculty research on the rise as Goizueta jumps up seven spots in intellectual capital. New leadership initiative inspires students.	B	B	B	B	A
101.0	74	55	As technology comes back into favor, recruiters remember an old favorite. Students appreciate the high-tech learning environment but lament the weak alumni network.	C	B	B	C	B
118.0	72	48	Snubbed by some recruiters who give grads low marks on analysis and teamwork. In need of technological improvements; student satisfaction falls 13 points.	B	C	C	B	B
110.0	64	56	Faculty recruiting efforts pay off as school gains ground in student poll. Grads laud the placement office's ability to connect them with nontraditional recruiters.	C	C	C	A	A
102.5	63	52	Still a reliable source for recruiters looking for solid business ethics, but grads say career services lacks the networking ability of a top school.	B	B	B	C	C
115.0	75	61	Maintains positive international reputation with recruiters. Enjoys a jump in the student poll because of steady improvements in teaching and job placement.	C	B	C	B	A
97.5	52	72	A recent shift to teaching entrepreneurship within corporations woos big-name recruiters. Grads praise the curriculum despite lackluster career services.	B	NA	B	B	D
100.0	55	66	Suffers a 15-point drop in corporate poll. Received average ratings from grads in all areas but alumni connections, where network is as strong as ever.	B	B	B	C	B
105.0	65	63	Building a tech-savvy reputation with recruiters. Grads find it tough to get face time with research-oriented professors. Alumni network needs strengthening.	C	D	C	B	B
105.0	71	55	Major recruiters dropped Simon from their short lists of campus visits since 2002. International students continue complaints about career placement.	C	B	C	A	B
102.0	66	61	Owen grads have yet to see the desired curriculum enhancements and diversity on campus. Recruiters still unsatisfied but notice some improvement.	B	B	B	C	B

THE BEST B-SCHOOLS

Edward A. Snyder, who joined the school in 2001. Just three years later, his ambitious plans to revitalize the school and shape the program's culture around its academic strengths and thought-provoking environment are bearing fruit, and Chicago has ended its inconsistent performance in the eyes of students. The success of this type of culture, says Snyder, hinges on the expectations he announced on Day One, including mutual respect, professional communication, and personal responsibility. Snyder's weekly roundtable breakfasts are a hot

ticket, and not just for the flapjacks. Every student (each class has about 500) is invited at least once to the anything-goes meetings. Just weeks ago, a big source of student gripes—poor facilities—was remedied when a new seven-story, 415,000 square-foot home for the business school opened.

If there's one lesson to be distilled from this year's ranking, it's that student satisfaction is cruci-

OPINIONS FOR BREAKFAST

Edward Snyder, dean of No. 2 Chicago, invites students to his weekly roundtables



The Best and the Brightest

Looking for a strong general manager? Need a marketing whiz? Recruiters rank the schools that produce grads with the best skills in a range of categories.

FINANCE	MARKETING	GLOBAL SCOPE	TECHNOLOGY	GENERAL MGMT.	ETHICS
1. Pennsylvania	Northwestern	Pennsylvania	MIT	Harvard	Northwestern
2. Chicago	Harvard	Harvard	Stanford	Northwestern	Pennsylvania
3. Columbia	Michigan	Columbia	Carnegie Mellon	Dartmouth	Harvard
4. Harvard	Cornell	Northwestern	Harvard	Pennsylvania	Virginia
5. Northwestern	Duke	Chicago	Northwestern	Michigan	Cornell
6. Duke	Pennsylvania	MIT	Pennsylvania	Virginia	Notre Dame
7. NYU	Virginia	Thunderbird	Chicago	Duke	Michigan
8. Stanford	Indiana	Michigan	Duke	Cornell	Dartmouth
9. Cornell	Dartmouth	Duke	Cornell	Columbia	Duke
10. Indiana	Stanford	Mellon	UC Berkeley	Chicago	Columbia

Data: BusinessWeek graduate stu-

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THE BEST B-SCHOOLS

al. At Wharton, a new building did little to remedy student unhappiness in 2002, when the school fell from its long-held No. 1 spot to No. 5. Waning student satisfaction, an ineffective placement office, and a dip in hiring by its most reliable recruiters led some to question whether the venerable finance school had lost some of its luster. But in 2002, Dean Patrick T. Harker hired Peter Degnan, a former investment banker, to overhaul career services, and students have taken notice. Says one Wharton grad, who landed a six-figure job at an investment management firm: "Degnan and his team have done an incredible job attracting employers, increasing the number of interviews and the number of job offers—all in a very short period of time." Recruiters noticed the well-oiled machinery, too—they named the placement office at Wharton the most effective of any school. It all added up to a No. 3 spot for Wharton this year.

Also on Wharton's improvement checklist: 23 new faculty across several disciplines and some fine-tuning of the program, including more "soft-skill" classes in communications, and experimenting with new interactive tools developed in the school's learning lab. And though students still complain about spotty teaching, Wharton's faculty—223 full-timers—rivals that of any program. That's borne out by the school's intellectual-capital ranking—based on published research and book reviews—which was among the best this year. It's not uncommon at Wharton to look down at a class textbook and find that your professor wrote it.

SCHOOLS OF HARD KNOCKS

FOR THE CLASS OF 2004, a school's intellectual prowess was just one way students judged a degree that was beginning to feel less valuable. Remember, the most recent group of MBAs applied not long after September 11, with the economy in tatters. They witnessed the layoffs of tens of thousands of employees, and some were downsized themselves. What's more, just a few months before applications were due, the Class of 2004 watched in disbelief as recruiters in 2002 reneged on job offers to hundreds of newly minted MBAs. An MBA was no longer a golden ticket, and more and more grads found themselves without jobs, even months after commencement. At the

Why They Say Yes

Now that they have more choice, MBAs want a lot out of their first postgrad jobs. Here's what the Class of 2004 considered the most important factors in accepting an offer:

	MOST IMPORTANT	SECOND	THIRD
Challenging duties	32.3%	19.0%	12.7%
Position	21.4	12.0	9.1
Room for advancement	17.0	22.7	7.7
Location	15.8	17.7	21.2
Pay package	8.5	21.6	31.0
Prestige	4.8	6.5	17.7

same time, B-schools continued raising tuition, making the price tag for the degree—already staggering—an even bigger reach. All of this at a time when pundits and even B-school insiders were questioning the value of the degree after a spate of corporate scandals that often involved MBAs. "It has been a sobering experience for the business community as a whole," says Bruce Willison, dean of UCLA's Anderson School of Business, No. 14 this year. "People are mindful of that as they decide to go back to business school."

The tumultuous state of Corporate America and the world of management education created near-perfect conditions for a backlash against the "glitz factor." In the late 1990s, many MBA programs catered far too much to student whims, sometimes to the point of dumbing down curriculum, reflecting the "I-want-more" culture that permeated the boom years. But the MBA is, after all, a \$100,000 investment, and the country club atmosphere just doesn't cut it anymore with students. "[The MBA] is really about investing in yourself, acquiring a knowledge base you didn't have before so that you have a professional future that's brighter," says Robert L. Johnson, dean of Stanford Graduate School of Business, No. 4 this year. "That has to come from effort and work, and there has been a growing awareness of that."

That may be why business schools known more for the tough academic environments have gained ground in the ranking this year with students and recruiters. Carnegie Mellon's Tepper School of Business, with a reputation for turning out grads skilled in quantitative analysis, shot up four spots to No. 15, and technology powerhouse Purdue University's Krannert School of Management leapt five spots, to No. 21. For Purdue, the improvement came despite student complaints that the career services office didn't do enough to help the

with job searches. They also said alumni contacts were barely useful in the hunt.

Schools that failed to meet students' intellectual needs paid dearly in the 2004 student survey. University of Southern California's Marshall School of Business fell 10 spots overall, to No. 10, and nine places in the student poll, to No. 23. In spite of a class boasting perhaps the highest average GMAT scores in the school's history, "the administration failed

The Big Payout

After a steep decline in pay in 2002, the Class of 2004 saw compensation rise smartly. The most handsomely paid are grads from:

SCHOOL	2004 MEDIAN PAY THOUSANDS	2002 MEDIAN PAY THOUSANDS	2000 MEDIAN PAY THOUSANDS
1. Stanford	\$150.0	\$138.1	\$165.5
2. Harvard	147.5	134.6	160.0
3. Pennsylvania	144.0	124.5	156.0
4. Columbia	142.5	123.6	142.5
5. Dartmouth	135.0	122.1	149.5

Data: BusinessWeek graduate survey



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THE BEST B-SCHOOLS



WORKING FOR IT Stanford (No. 4)
Dean Robert Joss believes that a tough program yields the best grad

Most schools had to pull out all the stops to maintain and strengthen relationships with companies—and get them to come back to campus. Cornell University's Johnson School of Business, No. 7 this year, used a private jet, loaned by its namesake, S.C. Johnson & Son Inc., to fly recruiters to out-of-the-way Ithaca, N.Y., for presentations and interviews. Some 29 companies took advantage of the unique perk to recruit first- and second-year students. And 14 job or internship offers from companies like GE Consumer Finance and IBM Global Services came about as a result of those trips.

Companies weren't just back in hiring mode for the Class of 2004. They were also more willing to pay a little more for grads' skills. Median graduate-reported total compensation—salary, signing bonus and other guaranteed payments—was up 26%, to an average

match the caliber of students with an equally tough and challenging curriculum,” says one grad.

This year's class saw the first signs of a recovery in the MBA job market after three years of lackluster recruiting. You could almost hear the sigh of relief. About 75% of grads at the top 30 schools had at least one offer by graduation. By three months after graduation, only 11% were still looking for work. That's in stark contrast to 2003, when nearly 35% of grads at the top schools were still pounding the pavement at summer's end. Harvard took the lead this year—94% of the Class of 2004 had at least one job offer by graduation. And even though students complained about the school's lack of connections with smaller recruiters, grads received an average of 2.6 offers per student—more than any other school.

\$136,569 in 2004. Many grads had something even better to be thankful for—a big part of the compensation increase came from companies paying off their loans. Others were just happy to see more recruiters on campus—and to be among the employed.

RETURN OF THE RECRUITERS

CAREER SERVICE DIRECTORS privately worried that 2004 wouldn't be much better than 2003. But in the spring, the phones started ringing. Banks and consultancies, months after fall recruiting ended, came back to campus to snatch up uncommitted grads. Hiring among consulting firms and banks that answered the *BusinessWeek* survey in 2002 and in 2003 was up 21% this go-round. And prospects are looking even better

Customer Satisfaction: Career Services

Recruiters are looking for top-flight grads to employ, but they also want a career service office that makes hiring easy. And students look for placement offices that meet their needs. How schools fared based on grad and recruiter surveys

BEST

- 1. Pennsylvania** New director energized students, won top marks from recruiters
- 2. Chicago** Makes recruiting easy for companies; grads rank it best
- 3. Northwestern** Grads laud school efforts; recruiters remain pleased
- 4. Cornell** Uses corporate jet to fly recruiters to Ithaca; grads praise career prep
- 5. Dartmouth** Students appreciate school's network; recruiters rate it uniformly high

WORST

- 1. Harvard** Receives lowest marks from recruiters, but grads noted improvement
- 2. Rochester** Grads say number, diversity of recruiters is average; recruiters equally frustrated
- 3. Maryland** Summer job placement help poor, say grads; recruiters indifferent
- 4. Yale** Grads say quality of recruiters is down; slips a dozen spots with companies
- 5. UCLA** Second worse among recruiters, but grads mostly pleased

Data: BusinessWeek student and recruiter survey



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THE BEST B-SCHOOLS

ter for the Class of 2005. "Two of the major firms hosted summer receptions for students who hadn't even started business school yet," says Sheryle Dirks, career services director at Duke University's Fuqua School of Business, ranking No. 11. "We haven't seen anything like that in at least five years." Students' growing coolness to hard-charging Wall Street jobs has pushed the banks, in particular, to be more aggressive in their recruiting (page 76).

And that's not all. Recruiters, who have long grumbled about MBAs who can't hit the ground running, now say MBAs are making a contribution from the get-go. Of those who responded to the *BusinessWeek* survey, about 50% reported that grads' skills and abilities were better today than they were

three years ago. Only 4% said grads were worse now than in 2001. "Before, everybody was going to business school just to go or because they were [laid-off]. Now, the people who are there really want to be there. It's more competitive to recruit, but the quality [of grads] is much better," says the head of a top consulting firm.

One reason could be that schools have become more innovative, adopting hands-on learning techniques designed to give them a taste of the business world they're about to inherit. What had been a smattering of experiential learning projects at a handful of schools has turned into a full-fledged phenomenon over the last few years. Students at most schools aren't just learning about structured finance, marketing stra-

How We Graded The Schools

BusinessWeek launched its biennial ranking of MBA programs in 1988, hoping to provide insight into top-tier schools. Evolving over the past 16 years, the surveys have incorporated new schools, expanded globally to include more non-U.S. programs, and added a measure designed to capture a school's intellectual clout. Above all, we have always taken the voice of the consumer to heart. Because we believe that customer satisfaction is a key indicator of performance, we focus on MBA students and the corporate recruiters who hire them.

This year, we sent a 45-question survey to 18,052 Class of 2004 MBA graduates at 94 schools in North America, Europe, Latin America, and Asia. Nearly all the schools assisted in our efforts to contact grads, though Harvard Business School and University of Pennsylvania's Wharton School declined for the first time to provide contact information. Using publicly available sources, we reached more than 90% of the Class of 2004 at both schools. Overall, we received 10,074 responses, a 56% response rate—below the 2002 showing but attributable largely to a falloff in Wharton's numbers. Even so, 273 out of 757 Wharton students participated. The online questionnaire asked grads to rate their schools on everything from the quality of teaching to the effectiveness of career services. We encouraged grads to think critically as they rated their schools on a scale of 1 to 10 for most questions.

The Class of 2004 graduate survey results count for 50% of a school's total student satisfaction score. An additional 25% comes from the responses of 10,039 graduates in the 2000 poll and 25% from 11,518 graduates polled in 2002. Measuring six years' worth of data ensures that short-term improvements or problems don't sway the results.

Next we put the data through a rigorous analysis to ensure that the results were not skewed by any attempts to influence student responses or otherwise affect the outcome. Once again, we called on statisticians David M. Rindskopf and Alan L. Gross, professors of educational psychology at City University of New York Graduate Center. They tested the responses to verify credibility of the data to guarantee the poll's integrity. A tiny number of surveys with obvious anomalies were discarded. Once the student poll data were certified, they received a 45% weight in the overall ranking.

We also invited corporate recruiters, who hire thousands of MBAs, to fill out an online survey. This year, with MBA hiring back in swing after a sour 2002 and 2003, companies had fresh perspectives. Of the 456 companies surveyed, 223 answered, for a response rate of 49%—down from 52% in 2002 but enough to maintain the poll's statistical validity. Among those were companies that hire anywhere from a handful of MBAs each year to those that hire more than 300 annually. Rather than allow multiple recruiters at individual companies to rank schools, which could skew the results, *BusinessWeek* allows only one survey per company, except in rare instances.

Recruiters were asked to rate their top 20 schools according to the quality of a B-school's grads and their company's experience with MBAs past and present. Companies could only rate schools at which they have actively recruited—on campus or off—in recent years. Each school's total score was divided by the number of responding companies that recruited from the school. Because there tend to be greater differences among schools in the corporate survey than in the student poll, recruiter opinion can have a bigger impact on the overall ranking. The recruiter poll accounted for 45% of a school's score.

Finally, we calculated each school's intellectual-capital rating by tallying faculties' academic journal entries in 18 publications, from the *Harvard Business Review* to the *Journal of Marketing*. We searched *The New York Times*, *The Wall Street Journal*, and *BusinessWeek*, adding points if a professor's book was reviewed there. The tallies were adjusted for faculty size. The final intellectual-capital score accounts for 10% of a school's final grade.

The Survey

GRADUATE POLL	2000	2002	2004
Surveys	16,843	16,906	18,052
Replies	10,039	11,518	10,074
Response Rate	60%	68%	56%
RECRUITER POLL	2000	2002	2004
Surveys	417	420	456
Replies	247	219	223
Response Rate	59%	52%	49%

Data: BusinessWeek



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THE BEST B-SCHOOLS



ON TARGET Michigan (No. 6) Dean Dolan, with profs Gretchen Spreitzer and Gautam Ahuja, won raves for leadership training

egy, or brand management. They're doing it. Through a variety of consulting projects, teams of students get a chance to test-drive their new skills.

At Kellogg, students have hundreds of opportunities to consult or work on real-life corporate projects—often as a supplement to a particular course. The combination has won them kudos from corporate recruiters who named the school's curriculum the most innovative. For example, students in technology marketing studied the latest marketing concepts for high-tech firms under the watchful eye of professor Mohan Sawhney and Dean Dipak C. Jain. Between pop quizzes and homework assignments, they consulted with senior management at Microsoft Corp., identifying business problems, writing case studies, and developing solutions for the company. Microsoft has already implemented several student marketing ideas related to its .Net initiative to sell Windows software as a service.

TURNING OUT LEADERS

ONE OF THE BIGGEST CHANGES in the B-school world this year has been a recognition among students that leadership is important. As important as, say, cost allocation or strategic planning. But teaching the fine art of leadership to Type-A MBAs is a challenge, especially when many already see themselves as destined for the corner office. Harvard Business School, alma mater of a sitting President and dozens of CEOs, made the biggest splash by making its first core-curriculum change in 25 years. Last fall, it launched a year-long required course on leadership and ethics, team-taught by 10 of the school's top professors (35 applied to teach it). Student response was overwhelming: One student wrote to a professor about his visit years earlier to a Polish concentration camp where he lost relatives during the Holocaust. The trip left him certain that human beings were incapable of changing their ethical stripes. "You have proven me wrong. While we become harder to convince over time, we are still... 'moldable' at any age."

Of course, Harvard doesn't own the market for creating leaders. Under Dean Robert Dolan, University of Michigan's newly named Stephen M. Ross School of Business expanded its flagship leadership program from one week to two and added a third week just before students graduate—and won raves from recruiters, pushing up two spots to No. 6. University of Virginia's Darden Graduate School of Business Administration, at No. 12, created leadership and ethics case studies from its own center dedicated to the subject. And Emory University's Goizueta School of Business moved up two spots to No. 20 this year, with grads giving it the highest score among all programs for the school's numerous efforts to nurture and

improve their leadership skills. Through a mix of seminar workshops, and year-long classwork, the school constantly reinforces the idea of leadership. Next year, Emory will add Leader's Academy for students who want even more training. They'll have to be committed, though—the academy meets on weekends and requires serious sweat equity in exercises that include working a minimum wage job and spending a long weekend at Marine Corps boot camp.

Grads who are grounded in the fundamentals but who also have business-building skills are in high demand these days. That's something that sets Babson College's F.W. Olin School of Business apart from its peers. "Companies can only do just so much with operating excellence or cost-cutting," says Dean Mark P. Rice. "At a certain point, you need new products, processes, and services. That's what drives revenue growth, and that's what Wall Street wants to see." In recent months he has received many requests to talk to executives at companies like Gillette Co. and United Technologies Corp. about innovation.

Babson, which enters the ranking for the first time at No. 2 this year, lives and breathes entrepreneurial zeal—even though upwards of 80% of its grads go on to work for traditional companies, which increasingly appreciate their creative thinking. Even hard-charging schools are getting on board the innovation bandwagon. R. Glenn Hubbard, recently appointed dean of Columbia Business School,

On the Move

The B-schools that saw the greatest improvement in their ranking...and the ones that suffered the steepest declines:

MOST IMPROVED

1. Purdue
2. Notre Dame
3. Georgetown
4. Cornell
5. Carnegie Mellon

STEEPEST DECLINE

1. USC
2. Yale
3. UC Berkeley
4. Maryland
5. MIT



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THE BEST B-SCHOOLS

hopes with a new mandate he can infuse a dose of entrepreneurial thinking into every course the nearly 500 MBAs take each year.

Such changes reflect a sense of optimism in the classroom that was fading two years ago. After surviving an economy in free fall and an unprecedented loss of faith in business itself, it wouldn't come as a surprise if the class of 2004 were a hard-nosed lot. But that's not the case—and with good reason. Recruiters are back, and schools are making meaningful changes. In the increasingly complex business world this year's grads have inherited, it may just be worth more than ever. ■

—With Erin Chambers
in New York

BusinessWeek online

View new profiles of more than 260 full-time MBA programs, with customizable school comparisons. Read admissions interview tips, sample application essays, interviews with career services directors, and over 60 MBA journals. Take virtual tours at more than 100 B-schools, or add your voice to the world's largest B-schools message board. View a dozen Q&As with deans, students, and recruiters at leading schools.

And, coming soon, an updated ROI Calculator and Who's Hiring too Plus, on Wed., Oct. 13: Beth Flye, director of MBA admissions at Kellogg, will take your questions. And on Oct. 20, INSEAD's admissions director will weigh in on application tips. For all of this and more, go to www.businessweek.com/bschools

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Wall Street? Thanks, I'll Pass

For years the annual migration of legions of B-school grads to Wall Street has been as sure a sign of fall as colorful foliage and back-to-school sales. But that all changed after investment banks laid off bankers over the last several years, and new recruits were among the first to be shoved out the door.

Now, being an investment banker is considered far from the white-hot career that it was in the go-go '90s. Investment banks have plans to hire as many as 30% more grads in 2005 than they did in 2004. That shouldn't be a problem, since it's still far below the number recruited at Wall Street's MBA hiring peak in 2000.

But nowadays, B-school grads are less interested in workaholic jobs at firms where some of the prestige is gone, the work is tougher than ever, careers seem less certain, and pay has been slashed by as much as 60%. One recent grad from Duke University's Fuqua School of Business, who interned on the trading desk at Goldman Sachs & Co. in 2002, took a job at troubled American Airlines after deciding that he preferred problem-solving over financial

transactions. In the 2004 *BusinessWeek* survey, 7.8% of grads said they were headed into investment banking, vs. 19% planning a career in consulting.

"Investment bankers are not masters of the universe anymore," says Alan Johnson, Wall Street compensation consultant. "They're not even colonels."

So where are most B-school grads going? A rising percentage have been choosing careers in marketing over dealmaking. Only 10% of the graduates of 11 top-tier business schools wanted to work for investment banks in 2003, down from 14% in 2000 and the lowest level in nearly a decade, according to a survey conducted by Duke's Fuqua school. By contrast, the percentage of graduates interested in marketing and management jobs jumped to 41%, up from 29% over the same period. "People look around and say: 'If I go into a field, what are my chances of being there in a year or two?'" says Daniel R. Nagy, associate dean at Fuqua. "If they perceive marketing jobs as more stable and more conducive to their lifestyle, then why not pursue one of them?"



Banks hope to reverse that trend by ramping up recruiting efforts and proving they care about grads' futures. "Our recruiting is more proactive," says Andrea C. Beldecos, manager of campus recruiting for Bank of America Corp.'s investment bank. Some of her recruiters ring up candidates as often as three times a week. At Goldman, top executives give interns

the hard sell over breakfasts. And heavyweights at Morgan Stanley are giving face time to small groups of students on campuses this fall after making large presentations. "They're all out there combing the bushes," says John R. Flato, director of the career management office at Georgetown University's Robert Emmett McDonough School of Business, a growing favorite among the banks.

Investment banks say they expect interest to continue to pick up along with their business. They may be right. But most research analysts expect the growth of investment banks' earnings to slow through 2005 and investment banking to remain moribund. If that happens, and another crop of newly hired MBAs ends up without jobs, it will take a lot more than sweet talk to win them back.

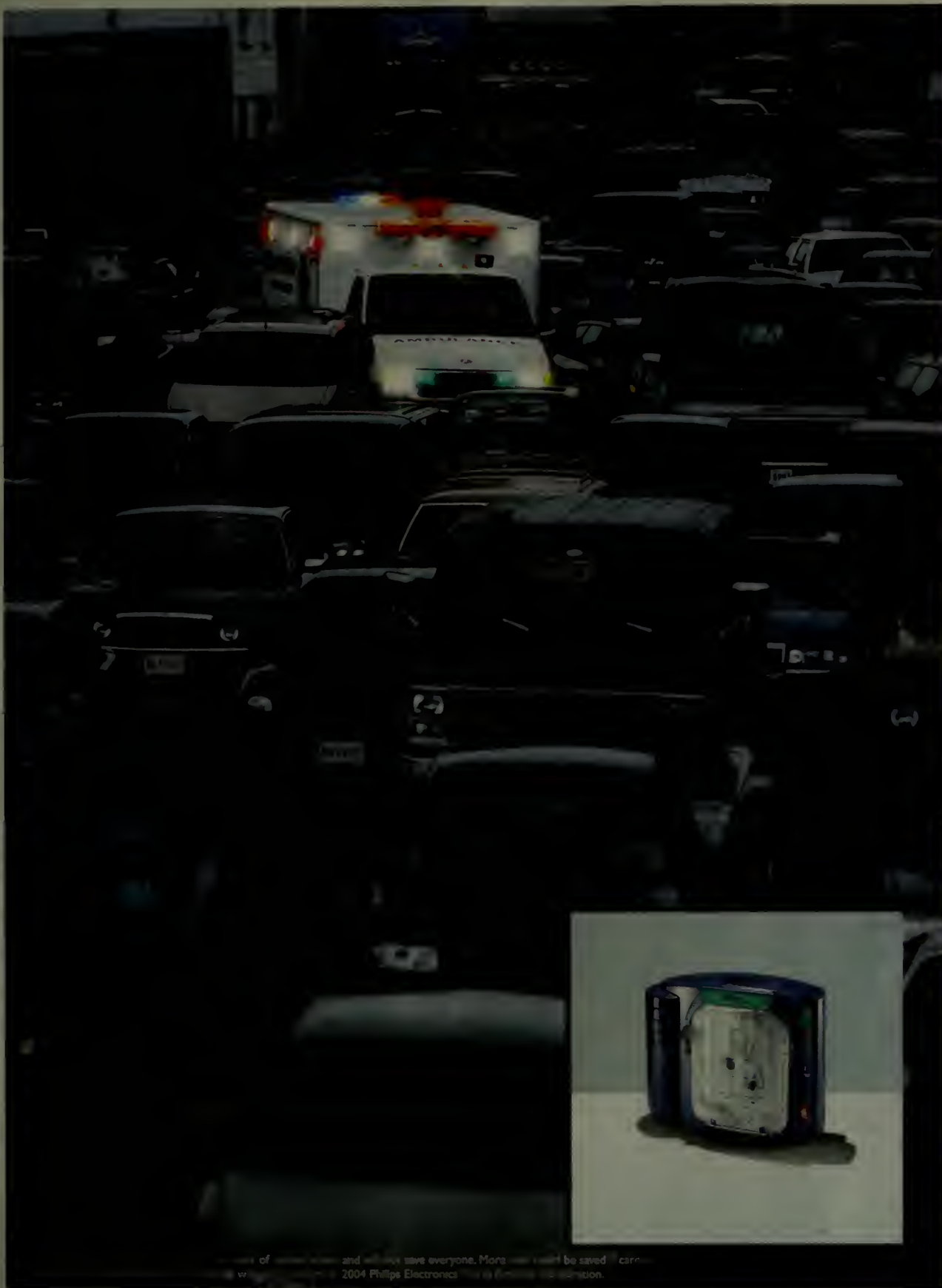
—By Emily Thornton in New York

Bearish on the Bulls

The percentage of MBA graduates from top schools who are interested in working for investment banks is the lowest in years

2003	2000	1998	1996
10%	14%	16%	14%

Data: Duke University's Fuqua School of Business



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ON DEMAND BUSINESS

THE BEST B-SCHOOLS

A Grad's-Eye View

Prospective MBAs shouldn't be concerned just with a school's overall ranking. They need to consider how each program stacks up against its peers in critical areas including academics and career services. Here's how students at the Top 30 schools answered 15 key questions out of 45 total in our survey:

1 Do you believe your MBA was worth its cost in time, tuition, and lost earnings?

SCALE: 1 = Return is 0%,
10 = Return is 100%

2 How would you rate the quality of the teaching in core courses?

SCALE: 1 = Poor,
10 = Outstanding

3 How would you rate the quality of the teaching in elective courses?

SCALE: 1 = Poor,
10 = Outstanding

4 Were the faculty available for informal discussion when classes were not in session?

SCALE: 1 = Never,
10 = Always

5 Were the school's most prominent academics actively involved in teaching in the MBA program?

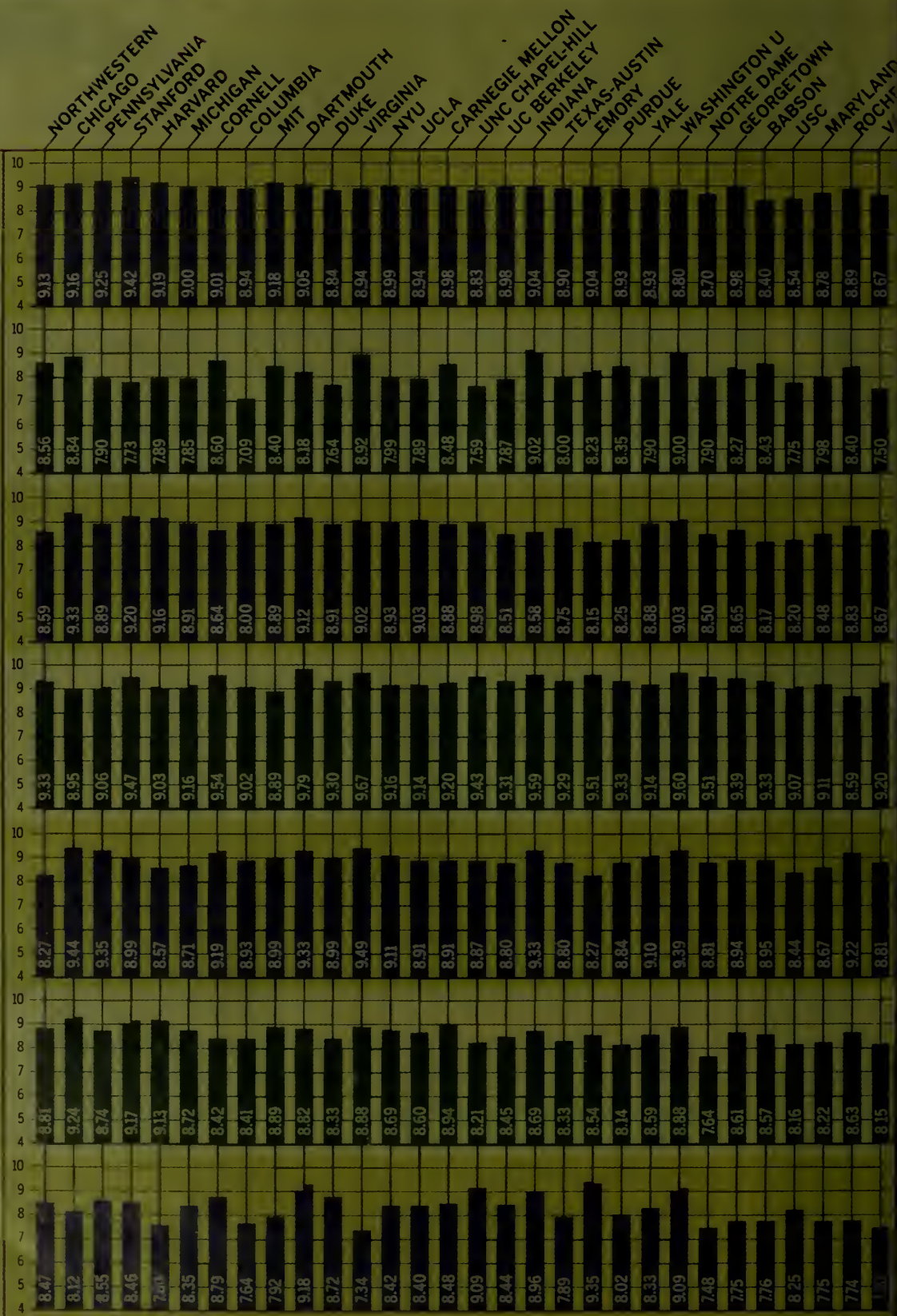
SCALE: 1 = Never,
10 = Always

6 How would you judge the school in providing you with numerous ways of approaching problems over the long haul?

SCALE: 1 = Poor,
10 = Outstanding

7 How would you judge the responsiveness of the faculty and administration to students' concerns and opinions?

SCALE: 1 = Poor,
10 = Outstanding



Note: Because no school scored below a 4.5, bar chart representation is shown for

How would you judge your school's efforts—in extracurricular activities—to improve your leadership?

10
9
8
7
6
5
4
3
2
1
Poor, 0
fading

How would you judge your school's network of 'connections' ability to help you throughout your career?

10
9
8
7
6
5
4
3
2
1
Poor, 0
fading

How would you judge the aggressiveness of your school in helping you with job placement or a career internship?

10
9
8
7
6
5
4
3
2
1
Poor, 0
fading

How would you characterize the performance in your school in helping you find a job before or after graduation?

10
9
8
7
6
5
4
3
2
1
Poor, 0
fading

How would you assess the number, diversity, and quality of firms recruiting on campus or posting jobs for career placement?

10
9
8
7
6
5
4
3
2
1
Poor, 0
fading

How would you assess your school's success in supporting your student search for a job?

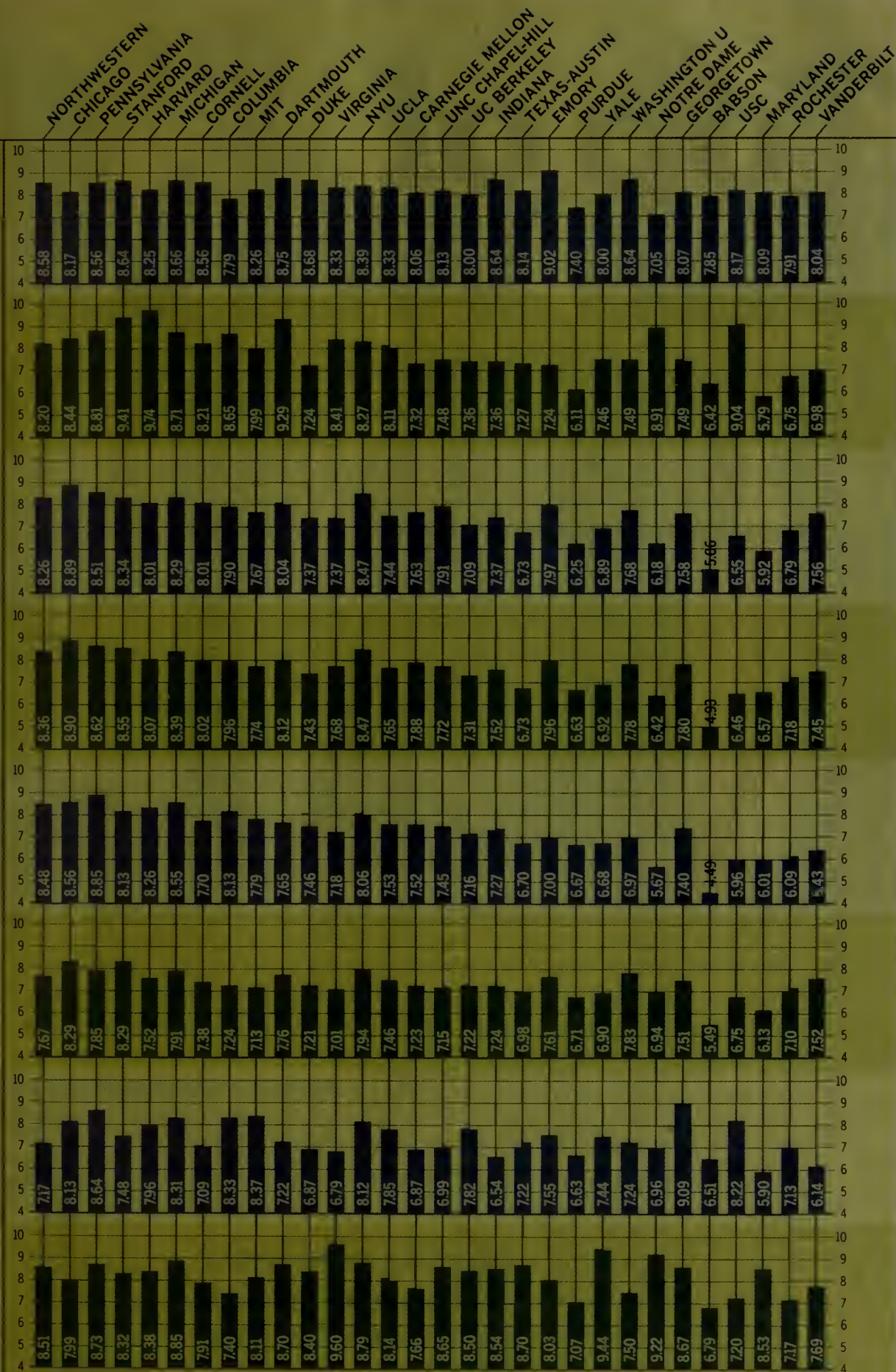
10
9
8
7
6
5
4
3
2
1
Poor, 0
fading

How would you judge your school's efforts in the area of international education?

10
9
8
7
6
5
4
3
2
1
Poor, 0
fading

How would you judge your school's efforts in the area of ethics?

10
9
8
7
6
5
4
3
2
1
Poor, 0
fading



Data: BusinessWeek student survey

Top of The World

In this year's poll, global MBA programs are showing themselves to be more selective, more rigorous, and more desirable to recruiters

AFTER 16 WEEKS OF WORKING ON THE SAME TISSUE SAMPLE, Tomi J. Nieminen came to a conclusion: He simply didn't have the patience for research. He had put in four years of pure science yet lacked the credentials to switch into the business side of medicine. So the then-27-year-old native of British Columbia, Canada, quit his job at Toronto General Research Institute and entered the MBA program at Queen's University in Kingston, Ont. One year later he graduated with a new job—business manager at the Hospital for Sick Children in Toronto.

Successes such as Nieminen's helped Queen's vault into first place in the 2004 *BusinessWeek* ranking of MBA programs outside the U.S. This year the Canadian program supplanted powerhouse INSEAD, which had held the top spot since *BusinessWeek* introduced its international ranking in 2000. That's no mean feat at a time when competition is fiercer than ever before. In fact, many programs abroad are gaining stature as they fine-tune their curriculums and boost faculty and student diversity to teach a more global brand of business. Says Gloria Batllori, full-time program director at ESADE in Barcelona: "We're getting better at responding to the needs of the market."

Consider Queen's specialized MBA program, which aims to convert science and technology professionals into general managers. Its 90 students per class are an impressive bunch: With an average age of 31 when they enter, they're already more mature than most MBAs, and a third have at least one other master's degree. Queen's got top grades from recruiters, who prize its students' analytical abilities and ethics. It was a dramatic leap for the niche program.

This year, *BusinessWeek* surveyed more than 2,000 students from the world's 20 most competitive programs and the recruiters who hire them, using the same methodology as in our U.S. ranking (page 72). Recruiters this year noticed a change. Some 75% said MBAs from international schools were as good, if not better, than their U.S. counterparts. At the same time, students now consider global schools a more viable alternative, and that shows in

an uptick in applications from around the world and the lectivity of the schools' admissions.

This year's international list holds other surprises, too. SEAD's campus in Fontainebleau, France, long a darling of recruiters, slipped two spots, to No. 3, in part because of waning attention from a number of big recruiters in financial services among others. A slight dip in student satisfaction contributed too, but more significantly, other global programs have proved, giving INSEAD a run for its money (page 86).

INSEAD's slip made room for another name player to climb to No. 2. The elite International Institute for Management Development (IMD) in Lausanne, Switzerland, accepts only every 8 applicants, for a class total of 90 students from more than 35 countries. The one-year program is intense—students typically put in 18-hour days. "There is really no other way to tell participants to take a picture of their spouse and kids because they won't see them for 11 months," says professor of entrepreneurship Benoit Leleux. Yet IMD's students laud the school's spirit of teamwork and ethics—as well as the jobs they're offered when they graduate, which tend to pay better salaries than those of other grads. "We like [IMD grads'] maturity and sound business judgment," says Anne Marie Klein, recruitment officer in Paris for Washington-based International Financial Corp.

NEEDED: A WIDER RANGE OF RECRUITERS

ALL SCHOOLS GOT DINGED by students for insufficient career services, however. During the late 1990s many international schools moved closer to the U.S. recruiting model, with formal presentations and structured hiring schedules. But in the softer job market, most companies reverted to recruiting on their

own schedules, with fewer visits to schools. Students scored career services the lowest of all elements in the survey.

At INSEAD, for example, students found the career-services office unresponsive, distant, and unhelpful pursuing less well-known companies. That's not surprising for a school j

In the one-year program at IMD, students work 18-hour days

SCIENCE EDGE Queen's University B-school dean David Saunders and students



International Report Card

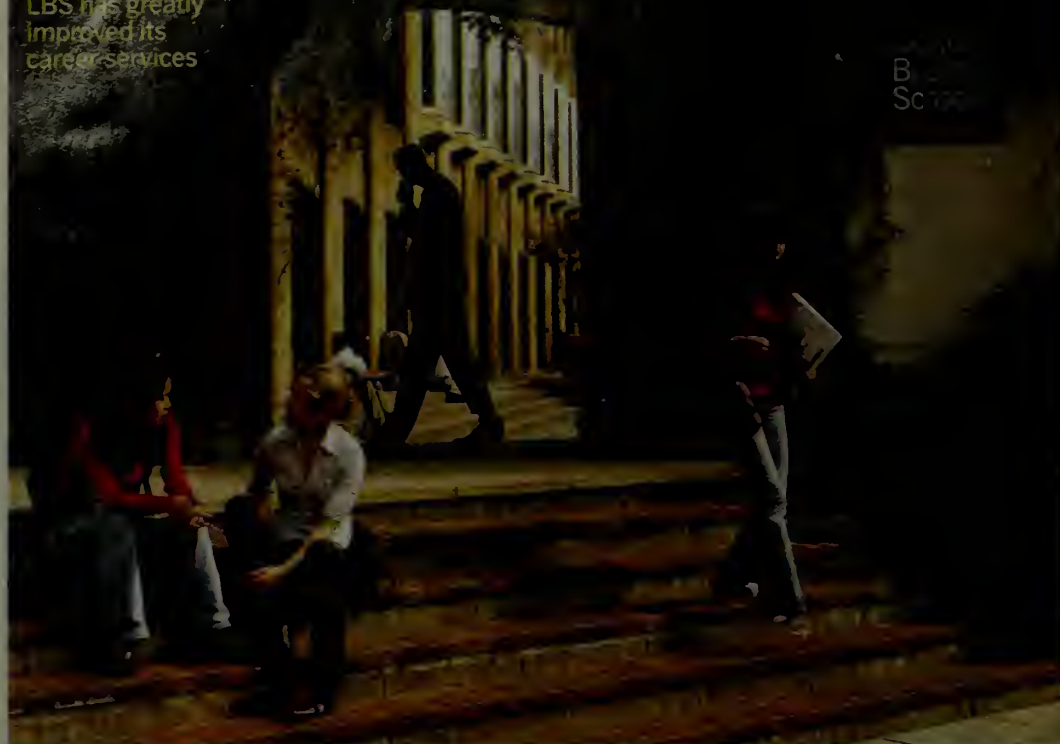
The top schools from Canada and Europe

RANK	SCHOOL	2002 RANK	CORP. POLL	GRAD. POLL	INT. CAP.	MEDIAN PAY (THOUSANDS)		DESCRIPTION	MBAs GRADED BY RECRUITERS		
						PRE-MBA	POST-MBA		GLOBAL SCOPE	ETHICS	
1.	Queen's Kingston, Ont., Canada	2	2	1	11	\$49	\$73	Students who enter with quantitative skills and leave as capable managers impress recruiters	B	B	
2.	IMD Lausanne, Switzerland	3	3	3	10	90	164	Europe's most elite student body wins praise from recruiters for humility and hard work	B	B	
3.	INSEAD Fontainebleau, France	1	4	4	1	70	115	Students rave about the Singapore program but find the Fontainebleau administration unresponsive	A	A	
4.	ESADE Barcelona	NA	1	10	12	40	63	Tops in recruiter ranking—and high with students, who applaud esprit de corps and dedicated faculty	A	A	
5.	London Business School London	4	8	2	2	65	129	Students give kudos to administration for revamping curriculum and wooing recruiters back to campus	A	A	
6.	Western Ontario London, Canada	6	5	7	3	44	65	Recruiters like cerebral grads, but students note that intense case-study approach can neglect basic skills	B	C	
7.	IESE Barcelona	8	10	5	7	48	68	Curriculum gets high marks from students, along with unmatched chance to master Spanish	A	A	
8.	HEC Paris	9	7	9	16	55	80	Enjoying a new global reputation built on leadership and reputation for team players	B	A	
9.	Toronto Toronto	5	11	12	4	38	70	Students give curriculum a thumbs-up, but jobs outside finance, consulting, and Canada remain slim	C	B	
10.	HEC Montreal	NA	9	11	15	40	46	Enters list for first time with solid scores from students and recruiters; most grads stay near Montreal	C	C	

Note: See page 72 for grading system.

THE BEST B-SCHOOLS

GREENER FUTURES
LBS has greatly improved its career services



ingly referred to as a satellite of McKinsey & Co., which does extensive on-campus recruiting. "If you're not going into consulting, forget about it," gripes one grad, who found his search for a consumer-products job disappointing. Canadian schools suffered, too, mostly from their localized recruiting ways, which frustrated graduates who wanted jobs outside the country, even though more than 72% had job offers by three months after graduation. Still, recruiters—including Canadian units of major multinationals—liked students' analytical skills and ethics.

When London Business School faced similar complaints in 2002, it scrambled to improve. Dean Laura D'Andrea Tyson (a *BusinessWeek* columnist) brought in a new head of career services, Graham Hastie, who had been a top McKinsey recruiter. He doubled the number of staffers devoted to bringing companies to campus and won improved marks from students. The school posted a No. 5 ranking this year.

SAVVY STRATEGIES

BOLSTERING CAREER SERVICES and tweaking curriculums to boost students' prospects helped others rise up the list. Barcelona's ESADE leaped into the rankings for the first time, at No. 4, with a big push from recruiters who say its grads have top-notch analytical and communications skills and—always good to hear—leadership. "They are the most entrepreneurial of the schools [where] we recruit," says Inigo Alonso, head of global recruitment for L'Oréal Spain. ESADE has been working its way toward the

rankings since 2000, when the school revamped its lax admissions policies of the 1970s. Out went young locals. In came 28-year-olds with five years' work experience and fluency in at least two languages. Adding to ESADE's global reputation: a first-ever journal that publishes student research from around the world.

Some schools rose in the rankings by looking beyond their borders. ESADE's crosstown rival IESE, moved up a spot, to No. 7, applauded for its reach into Latin America. That makes the program fertile recruiting ground for companies with a presence in both Europe and South America. And after a decade of ramping up outreach efforts in Europe, Asia, and the U.S., HEC Paris too, has gained ground. The school boosted its global student percentage to 80%, from 54% in 1998. "It's the students who

make HEC," says Judson Horn, 31, a U.S. alum now consulting for J.P. Morgan Chase in New York. "No one can compete with their diversity and experience from all over the world."

Also rewarded for its global reach is the Richard Ivey School of Business at the University of Western Ontario, at No. 6. It's the largest producer of case studies after Harvard Business School and leads the world in output of Asian case studies. Recent grads rave about the 400-plus case studies they dissected and a curriculum that includes courses on how to job-hunt and how to mine alumni connections. It's working: The school moved up two places with recruiters. "Ivey graduates [have] strong academic achievement and analytic ability as well as leadership, drive, and initiative," says General Electric Canada staffing manager Terry Peach.

International MBA programs might once have been perceived as parochial cousins of U.S. programs—good, just not great. But they're becoming an increasingly desirable choice for would-be MBAs everywhere. With foreign students in the U.S. facing visa problems and ever-slimmer chances of staying after graduation, international schools are likely to get even more opportunities to prove themselves in the years ahead. ■

—By Kate Hazelwood in New York

Mining for Talent

Recruiters say these schools turn out the best and the brightest in these areas

GENERAL MGMT.

1. IESE
2. ESADE
3. INSEAD
4. IMD
5. HEC Paris

FINANCE

- IESE
ESADE
INSEAD
HEC Paris
Bocconi

MARKETING

- ESADE
IESE
INSEAD
LBS
HEC Paris

COMMUNICATION

- ESADE
IESE
INSEAD
W. Ontario
LBS

TEAMWORK

- ESADE
IESE
INSEAD
Empresas
HEC Paris

Data: BusinessWeek recruiter survey

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New Strength In Europe

These schools aren't content to be also-rans anymore, and they're making a play for top students

BARCELONA A HOT SPOT FOR BUSINESS PRINCIPLES?

Paris a champion of the management study? Across Europe, a new energy is percolating in business schools, as they shrug off their provincialism and aim full force at the global marketplace. Lesser-known schools such as Spain's IESE and ESADE, France's HEC Paris, and Cambridge University's Judge Institute of Management now boast international student bodies, top-flight faculty, and partnerships. They're increasingly viewed as smart choices by companies seeking MBA talent or exec-ed programs and as an attractive alternative for the B-school bound. They're even becoming troublesome rivals for more established European business schools. Admits Laura D'Andrea Tyson, dean of London Business School, one of the top European outfits and a powerhouse worldwide: "We're beginning to compete with them for students."

These programs on the rise still face plenty of challenges. Tightfisted alumni unaccustomed to giving and paltry endowments hobble major educational initiatives. Antiquated forms of schooling and red tape that until recently limited enrollment to native students are disappearing, but the recruiting problems they created still linger. And in cultures that do not bestow the kind of prestige on MBAs that the degree enjoys in the

U.S., the potential for in-country enrollment growth is limited.

So the up-and-comers' focus on going global is one part necessity, one part luck, coming as it did just as the European Union opened up most of the Continent. More companies were crossing borders to take advantage of business opportunities that had increased exponentially with each new member nation—raising the profile of all the B-schools dotting the European map. Suddenly scale was possible, rather than serving just one country. To become a top-flight school in Europe says Jordi Canals, dean of Barcelona's IESE, "you had to focus outside your local market."

LOOKING FOR PARTNERS

AND SO THEY DID. After Spain joined the EU in 1986, IESE and Madrid's Instituto de Empresas set about making their presence known across Europe and in Latin America, where Spain quickly became the No. 2 investor in the economy. In stepping up their efforts to become world players and recruiting a wide swath of students and faculty, the two eliminated their Spanish-only classroom requirement, teamed up with companies investing in Latin America, and began partnering with other European and U.S. schools to deliver executive education programs.

For HEC Paris, the need to go global was even more pressing. About a decade ago, the school's dean, Bernard Ramanantsoa, noticed that French companies were no longer snapping up grads educated in prestigious French business schools. At the same time, other European recruiters were snaring the top French graduates. So HEC put multinational CEOs on its executive board, expanded its exec-ed offerings outside of France, and began marketing itself internationally. "We were facing a kind of globalization," says Ramanantsoa. "We decided to be more than only a French business school."

As that attitude swept across Europe in the 1990s, administrators set about systematically steering their institutions in more global direction, much like LBS, France's INSEAD, and Switzerland's IMD, the reigning European schools, had done from the start. To lure top-notch teachers, the schools boosted research grants and otherwise encouraged a new culture of scholarship. Today more than 40% of faculty at many of the smaller programs are international, up from about 5% in 1990. The schools also had to compete on salary to attract talent from the U.S.; the dollar's decline against the euro and the pound since early 2003 has helped considerably.

The growing perception of European schools as centers of real scholarship paved the way for other changes. International enrollment in the second-tier MBA programs has exploded since 1990. Fewer than 15% of students were non-

Europe's Go-Getters

Second-tier schools have transformed themselves from nation-centric to global programs. They're giving Europe's stalwarts—not to mention U.S. schools—tough new competition

SCHOOL	NON-NATIVE FACULTY		NON-NATIVE MBA STUDENTS		NON-NATIVE EXEC ED CLIENTS	
	1990	2004	1990	2004	1990	2004
HEC-Paris	6%	25%	15%	84%	5%	52%
IESE	5	34	30	70	0	42
Instituto de Empresas	25	44	35	72	0	49
ESADE	5	17	21	70	1	15
Cambridge	16	43	45	87	NA	65

Note: Schools with NA had no executive education business in 1990

Data: BusinessWeek



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THE BEST B-SCHOOLS



A big push in Latin America

native at some schools as late as 1998, but most now boast diverse campuses, with students hailing from six continents. With the myriad difficulties foreign students have had enrolling in U.S. MBA programs since September 11—let alone finding work at graduation—European schools have become more attractive. U.S. students looking for a more rounded international business education have also turned to the smaller schools. “American applicants are increasingly viewing a European MBA as a means of differentiating themselves in the business arena,” said Matt Symonds, director of the World MBA Tour, which organizes forums for prospective B-school students around the world, in a recent paper.

ONE-STOP SHOPS

THE THINKING IS STILL CHANGING among prospective MBA students, but corporations are already there. Big multinational companies like Ford spin-off Visteon Corp. and Nissan are more frequently choosing lesser-known international schools for exec-ed programs and as a source for MBA-educated talent. Part of the appeal for companies is their global reach. And for others in search of exec-ed programs and students on the MBA track, a distinct European business sensibility is the draw. The scandals of recent years and the dot-com bust spurred even more interest in alternatives. “At European schools, you’re learning in an environment where the stakeholder culture is more the rule, compared to the shareholder culture that is prevalent in the U.S.,” says Empresas Dean Santiago Iñiguez.

Just as attractive to companies and students, the new go-getter schools have embraced the idea of partnering. IESE and HEC team up with others across Europe, Asia, Latin America, and the U.S. to create executive programs, drawing on experts from different schools to flesh out content and teach courses in far-flung locales. They have won over corporations that want the best available faculty but also a one-stop shop for executive programs—something most U.S. and big European schools have been unable to deliver effectively. “With the big schools, it’s like changing the direction of a tanker ship to meet a company’s needs. We were able to say: ‘We can do that,’” says

to offer Trium, an EMBA designed for senior execs of multinational companies. Those cross-country alliances have added to the European schools’ new cachet.

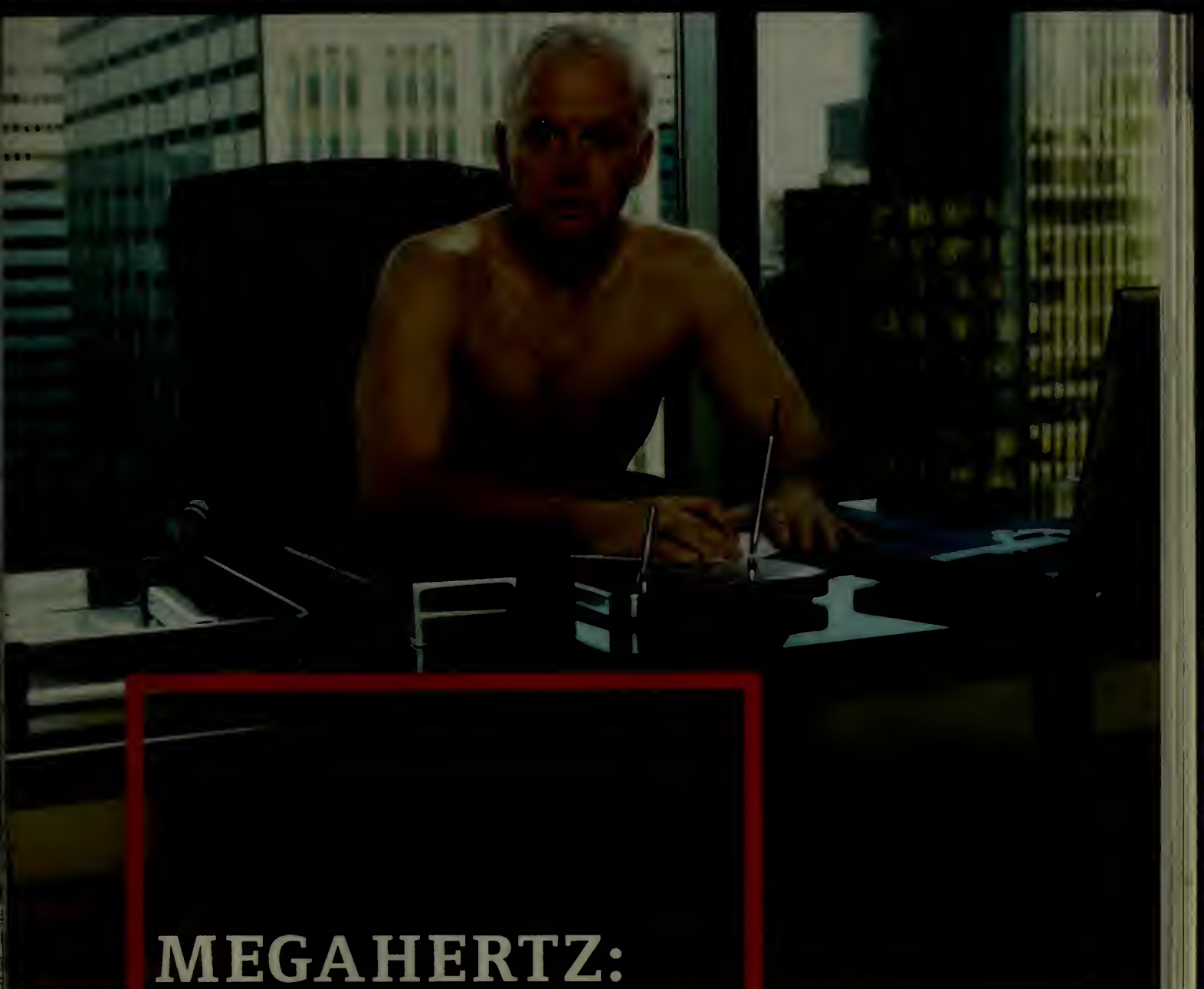
Still, keeping up the momentum will be tough. Until the early 1990s most schools were hamstrung by state regulation requiring instruction in the native tongue—making it nearly impossible to attract multinational faculty, students, or corporate partners. That’s changing, but in a global B-school marketplace dominated by brands such as Harvard, Stanford and Wharton, many European schools still lack the name recognition that lures money and talent. Indeed, the very idea of business schools took a while to gel in Europe. “Graduate professional education is mainly a U.S. invention,” says Canals. “This is something we did not have in Europe 50 years ago.” The Bologna Declaration, signed by 29 countries in 1999 to be phased in by 2010, aims to make Europe’s higher ed system more uniform—closer to the U.S. model of undergraduate study, followed later by a master’s degree. That could help spur interest in the MBA even more.

Meanwhile, though, simply filling the coffers can be a struggle. Most of Europe’s schools operate in cultures where alumni giving is virtually unheard of and where endowments are small compared with most U.S. schools, the most elite of which control upwards of \$500 million. What little money there is often is tied up in funding for faculty chairs, unlike the schools’ U.S. counterparts, which have largely unfettered use of their endowments. At Cambridge’s Judge Institute of Management, for example, about 42% of its \$63.8 million endowment is committed to professorships. In 2003, Cambridge appealed to its alums to raise \$446,000 to improve its library and upgrade its facilities. They took in only half that amount—and only 10% of alumni ponied up.

In the next few years, though, look for the second-tier schools to take their place alongside Europe’s top-ranked academies, as the efforts of the previous decades begin to pay the kind of dividends that matter: solid reputations among prospective students and global corporations. ■

—By Jennifer Merritt in Paris
with Mica Schneider in London

Where alumni giving is rare, simply filling the coffers is tough



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THE BEST B-SCHOOLS



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Welcome To Ethics 101

B-schools are trying a host of new methods to teach MBAs lasting lessons in leadership principles

GUILTY AS CHARGED. THAT WAS THE VERDICT DELIVERED IN A mock court in August when MBA students at Duke University's Fuqua School of Business put their program on trial. The indictment: that Fuqua, one of the nation's premier B-school programs, was failing to teach the tenets of corporate leadership. With only one required course on ethics or leadership and a code of conduct with too few penalties for violations, the Duke program, students concluded, inadequately prepared them to be ethical business leaders. For Amy Pierce, a second-year student assigned to a prosecution team in the trial, the verdict was troubling: "The bummer of what we learned is that Team Fuqua promotes not holding each other accountable." It's something the B-school is now working to remedy—an academic committee has begun looking into solutions.

Despite several years of corporate scandal, some of it courtesy of top B-school grads, many MBA programs are still grappling with the most effective way to teach the sticky subjects of ethics and leadership. Some have added courses and seminars or encouraged professors to weave the subject into coursework. Duke's warts-and-all attempt to force students to think about

leadership and ethics in a mock trial format—and take it from a squishy classroom concept to something closer to reality—one of a handful of out-of-the-ordinary methods B-schools are trying.

For eight years, University of Maryland's Robert H. Smith School of Business has put a real-life spin on ethics by taking second-year MBAs to visit white-collar mates in federal prisons. There, prison some of them former high-level executives with MBAs convicted of everything from securities fraud to skimming funds, their life stories—awfully familiar or "Their backgrounds were so similar [ours], and they did jobs we are going to be doing," said Kevon Kothari, a 2000 University of Maryland MBA grad who now works at Intel Corp. It was the story of a young entrepreneur, serving many years for trying to tamper with a racetrack

computer system, that resonated most with Kothari. After the man's conviction, his wife divorced him, and he hasn't seen their child since. Says Stephen E. Loeb, the Maryland professor who leads the scared-straight program: "You go through that and you'll never forget it."

CODDLING AN EGG

GETTING LOST in the Chilhowee Mountains of Tennessee is something no MBA would soon forget, either. At Emory University's Goizueta Business School, at least one team usually ends up losing its way in the eight-hour "Amazing Race" style leadership challenge, launched two years ago. With a compass, a rough map, and meager supplies, teams of MBAs climb over a mountain, raft 10 miles down a river, trek back to the other side of the mountain, and finally go on a five-mile mountain bike ride—all the while protecting a raw egg. The idea, says associate Dean Kembrel Jones, is to teach leadership and responsibility by having a different student lead each leg of the trip, motivating team members, making key decisions, and suffering the consequences should things go wrong. Says Jones: "They're physically tired, but the concepts we talk about in our leadership and communications classes come through."

While many students find these programs instructive, they have their critics. Patrick T. Harker, dean of University of Pennsylvania's Wharton School, says some efforts—unlike Wharton's intellectually rigorous ethics program—are "gimmicks" that won't endure once Enron, Adelphia Communications, and Tyco International fade from memory. But others say the courses represent real change. "MBAs have a responsibility to society," says Sim Sitkin, director of Duke's leadership and ethics efforts. "It's not enough that you aren't indicted." True, but it's a start.

—By Jennifer Merritt in Durham, N.C.

Taking Charge

Grads praise these schools' training efforts

LEADERSHIP

- | | |
|--------------|-------------|
| 1. Emory | 4. Michigan |
| 2. Dartmouth | 5. Stanford |
| 3. Duke | 6. Virginia |

Data: BusinessWeek student survey

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Global Markets & Investment Banking Group

Is the Focus Too Fine?

B-schools are narrowing down their core curriculums in favor of programs that develop marketable skills

AT INDIANA UNIVERSITY'S KELLEY SCHOOL OF BUSINESS, students plan for their future career as soon as they set foot on campus. They don't have a choice, actually. Students must apply for admission to one of the school's 11 academies—a mix between a club and a carefully tailored learning center geared toward a particular industry, from investment banking to health care to consulting. Plug in a few more career goals, and the computer spits out a highly specialized curriculum for the newest crop of Indiana's prospective MBAs.

The MBA has long been viewed as a general management degree designed to educate students in business basics. But at Indiana and a growing number of campuses, core curriculums are giving way to electives, and early specialization is the order of the day. Under pressure from recruiters to produce graduates with marketable skills—and students who want a leg up on their careers—many schools are transforming their programs into something akin to a two-year job search.

It's not a universally applauded trend, by any means. Critics say it sacrifices a broad understanding of core business ideas, such as finance, general management, and strategy. And for what? In many cases, they say, just a shot at an entry-level job. Many programs today are "heavily compromising the education they provide," complains one MBA student. "The companies are the dogs that wag the business schools' tails."

At some B-schools, the concept of specialization has been taken to such an extreme that core curriculums have been squeezed down to a single semester. That can free up students to pursue a finely tuned course of study as soon as the second semester. The hope is that specialized coursework will give them an edge in the highly competitive market for summer internships.

Officials at the Keenan-Flagler School of Business at the University of North Carolina and the McComb School of Business at the University of Texas at Austin say specialization makes students more employable. Previously at Indiana, academy-enrolled

students were far more likely to secure internships and receive more job offers in their field than those who have opted out, which is why the academies are now required. What's more, says Idalene F. Kesner, chair of Indiana's MBA program, "students go into their careers with more knowledge about the players and companies in their chosen fields."

PREPPED UP

COMPANIES ARE BIG SUPPORTERS of the move toward specialization, citing the level of preparation their new hires bring. UNC Associate Dean Valarie Zeithaml says top recruiters, including those from Tropicana and DuPont, pushed the school toward specialization in 2003 for just that reason. "We need to build skills, not just knowledge," she says. So the school has whittled down requirements, offering students a "custom core" during their second semester. Students pick four classes from a selection of six, including corporate strategy and information technology, depending on their career goals.

At Massachusetts Institute of Technology, the Sloan School of Management has condensed its entire core into just one semester, allowing students to take electives for the next three semesters. Most use career "road maps" that guide students to appropriate courses. "[MBA students] are adults, and they have a decent sense of what they want," says Margaret Andrews, executive director of the MBA program at Sloan.

But what Andrews and others see as a boon to students, some see as a disservice. Slashing the core courses may be convenient for students about to interview for internships, but it can also cultivate middle managers, not leaders, some insist. James M. Danko, dean of Dartmouth's Tuck School of Business, which endorses an in-depth but generalized approach, believes the push to specialization shortchanges students in the long run. Sure, it may help a student get that first job—but what about the rest of the MBA's 30-year career? "A more vocational degree detracts from the ability to develop the whole person and leadership capabilities," says Danko. So dissatisfied is R. Glenn Hubbard, dean of Columbia University's Graduate School of Business, with the trend toward silo-like MBA education that he's waging a campaign against it, penning position papers about the dangers of narrow specialization.

In the end, the controversy over specialization amounts to one more debate about the meaning of the MBA. Is it an academic challenge, or a passport to a glittering business career? For the best schools, it's probably some of both. ■

—By Diana Middleton in New York



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COMMENTARY

BY ERIN CHAMBERS

Too Much of a Good Thing

Adjunct faculty are hot. But B-schools may be going overboard

JAMES C. VAN HORNE COULD BE A TEXTBOOK EXAMPLE OF the perfect professor. With his commanding presence and exacting standards, the 69-year-old banking-and-finance expert at Stanford University's Graduate School of Business makes even fixed-income derivatives seem exciting. The waiting list for his corporate finance class is the B-school's longest, even though he's famous for "cold-calling" on unsuspecting students seated on the aisle. With dozens of teaching awards and publishing credits, he's the kind of instructor B-schools like to boast about—and wish they had more of.

But seasoned professors such as Van Horne are rarer than ever. These days, B-schools are relying more on adjuncts—practicing professionals without doctoral degrees or much teaching experience. They were less prevalent a decade ago, when plenty of fresh PhDs were looking to teach. But with fewer students getting doctorates in business—and fewer of those choosing to teach—the shortage of full-blown professors has grown more acute. So schools are looking among the ranks of alumni and their companies to fill vacancies. In a competitive MBA market, schools also feel pressure to spice up the curriculum with popular electives taught by big-name executives.

The result: increasingly divided programs that may be undermining their academic foundations. On one side is a shrinking corps of research-oriented profs who provide intellectual firepower but spend less time with students. On the other, hotshot executives who regale students with real-world war stories but lack educational training. Caught in the middle are students who want the best of both worlds: a highly engaging classroom experience as well as access to the best minds in academia. To maintain rigor and protect their franchises, B-schools need to strike the right balance and not go overboard with adjuncts.

After all, the MBA is an intensive academic degree. When students are taught more by practitioners, not re-

searchers and academics, the experience moves closer to trade school. When that happens, students lose out—on cutting-edge research and complex business topics taught by tenured faculty and the insights they develop consulting big companies.

CELEB GLAMOUR

CERTAINLY SOME PHDs CAN SEEM disconnected after years in the ivory tower, making experienced execs welcome in the classroom. And adjuncts—who are paid less than professors and are for the most part more popular with students—can seem like a real bargain. That might explain their popularity on some campuses. At Columbia Business School, an average commute from Wall Street, there are nearly as many adjuncts (89) as full-time faculty (115). One-third of the 90 faculty members are adjuncts at University of Virginia's Darden Graduate School of Business Administration. Stanford counts 27 adjuncts and 102 full-timers. That 27 is up from 18 years ago. In subjects such as entrepreneurship and real estate, which attract few majors, "it's just not cost-effective to hire full-time faculty," said Stanley J. Garstka, a dean at Yale School of Management, which has 30 adjuncts on its 80-member faculty.

Some schools are able to figure out a good mix, maintaining academic discipline even as they hire more adjuncts. Yale pro-

fessors help adjuncts with syllabus development. At Stanford, high-level execs co-teach with seasoned professors. The most popular course: Information Technology Industry, taught by Intel Corp. Chairman Andrew S. Grove and management professor Robert Burgelman. Mentorships give students one-on-one time with executives through meetings and corporate visits and connect students with the real world without cutting into face time with professors. Southern Methodist University's Cox School of Business partners with execs at Dallas companies such as Frito-Lay, J.C. Penney and American Airlines.

There's no doubt schools feel pressure to please MBAs in the dog-eat-dog B-school market. But an entertaining semester does not equal one of rigorous instruction in essential business topics. Schools confuse the two at their peril. ■



VAN HORNE
A favorite
at Stanford

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Corning: Back From the Brink

How retired CEO Jamie Houghton rescued his family's 150-year legacy

IN EARLY 2002, JAMES J. O'CONNOR, the lead outside director of Corning Inc., quietly began a campaign to replace CEO John W. Loose. Such unrest was unheard of at Corning, which for most of its 150 years had been governed by the descendants of founder Amory Houghton Sr. "But I felt the business was in a meltdown, and time was running out," says O'Connor. Just two years earlier, Corning had been a high-tech star, with \$7 billion in sales and a market value of \$100 billion. But now tornado-force winds were whipping through the telecom industry, slicing sales by more than half, sending the stock down 95%, and raising fears that Corning—one of America's oldest and most innovative companies—might not survive.

To have a chance, "we needed someone at the top whom everyone could rally around," says O'Connor. In the board's view, there was only one credible candidate: retired CEO James R. Houghton, 68, who had turned Corning over to an outsider in 1996 after 13 years at the top.

After the board approached him, Houghton went to see his older brother Amory at the hideaway suite of offices they keep above Market Street in Corning, N.Y.,

two blocks from the company's headquarters. "Jamie didn't particularly want to do it," recalls Amo, as he's universally known in town. Jamie was engrossed in a glittering second career in the nonprofit world, serving as both chairman of the Metropolitan Museum of Art and as "senior fellow" of the Harvard Corporation, the super-secret body that governs the nation's premier university. But as the brothers talked, Jamie realized that he needed to answer the call, just as Amo had stepped in to lead the recovery effort after Hurricane Agnes flooded Corning in 1972. He knew what the townspeople would say: "The Houghtons have been around a long time. They're going to fix it."

"WE WILL SUCCEED"

SURE ENOUGH, HOUGHTON electrified the company and its hometown in his maiden speech at the annual meeting a few weeks later. He compared Corning's predicament to the darkest days of World War II and his role to that of Winston Churchill's. He vowed that Corning would reinvent itself just as previous generations had invented the technology for mass-producing Thomas Edison's light bulb, the glass tubes that fueled the ex-

HOUGHTON
He vowed to spur Corning to reinvent itself—again

plosive rise of TV, and optical fiber, which ultimately made the Internet possible. "I am confident of victory," he concluded. "We will succeed." Within days, "We Will Succeed" posters, banners, and buttons had popped up everywhere.

Betting on The Future

Corning's R&D dollars are chasing several bold innovations, all of which face steep hurdles

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Challenge: To prove that this technology is more accurate and efficient than existing drug-screening methods.

MICRO-REACTORS

Small glass reactors that will let specialty chemical makers control chemical reactions, improving discovery of new compounds.
Challenge: To overcome inertia by proving that these new reactors are reliable and cost-effective.



to persist well beyond 2005. On Oct. 6 the company announced it will take \$2.8 billion in noncash charges against third-quarter earnings, primarily related to a writedown of goodwill and assets in its telecom business. Still, in the first half of 2004 sales jumped 21%, and Corning earned \$163 million, a sharp turnaround from the more than \$7 billion in losses it has posted since 2000. Houghton has cut debt nearly in half, to \$2.7 billion. And he says he has a replacement for fiber: Corning is the leading producer of ultrathin glass for the liquid-crystal displays (LCDs) in TVs and computer monitors.

HEFTY INVESTMENTS

DURING HIS EARLIER term as CEO, Houghton nurtured the LCD business through years of losses. Now that investment is paying off. Overall demand for LCD glass is expected to triple by 2008, says Paul Semenza, vice-president of El Segundo (Calif.) market researcher iSuppli Corp. Corning equips more than half of the LCD market, and this year alone Houghton is sinking \$800 million into boosting capacity, triple last year's spending. LCD is the key reason Corning has recovered faster than such pure-play telecoms as Nortel Networks Corp. and JDS Uniphase Corp. Before the fiber writedown

Corning is the leading maker of glass for LCDs

was announced, Corning's stock was trading at around \$11. That's up from \$1.10 in late 2002—but far below its high of \$113 in September, 2000.

Corning may never see those lofty heights again. To keep growing at its current pace,

Houghton must surmount some formidable challenges. By spinning off its glass cookware and health-care services businesses in the '90s, Corning traded stability for faster growth. Now, Houghton is betting that his scientists can solve some of the thorniest problems facing society, such as how to build a fuel cell that could revolutionize electricity generation. That requires hefty investments in research and development—\$344 million last year, or 11% of sales. And that kind of R&D can take years to pay off. Corning lost money for 17 years on optical fiber before the market took off.

Meanwhile, Corning has to be careful that it doesn't end up with a glut of LCD capacity, as it eventually did with fiber. Houghton's two other big bets are on

Despite the bravado, Houghton knew success was far from guaranteed. That summer, hedge funds would bet against Corning, nearly sinking its efforts to raise the cash it needed to stay afloat. Houghton could have to gut Corning's world-leading

optical-fiber business and entirely exit the photonics business, which had been its brightest hope during the telecom boom. Ultimately he would have to slash the payroll in half, by some 20,000, to save \$2 billion. "We have been through a hell worse than the Great Depression," says Thomas E. Nettleman, manager of Corning's remaining operating fiber plant in Wilmington, N.C.

Today, Corning's survival is no longer in doubt. True, the fiber optic market—still Corning's biggest business—remains deeply depressed. Corning is only now acknowledging that those conditions are likely

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PHOTONIC BAND GAP FIBERS

Next-generation optical fiber that could revolutionize telecom and enhance the use of lasers in manufacturing and defense. **Challenge:** To demonstrate that these are superior to existing fibers, and to make uniform fibers on a commercial scale.

Management Dynasties

technology to bring high-speed fiber directly to homes and offices and a ceramic filter that could dramatically reduce emissions from diesel engines. Both are still losing money. And because of its heavy investments in R&D and LCD production, Corning says it could burn through up to \$100 million in cash this year. "They need to be generating cash to move back to an investment-grade rating," says Robert Schulz, a director at Standard & Poor's. S&P's rating on Corning's bonds is BB+, a notch below investment grade.

IN HIS VEINS

PERHAPS MOST daunting, Houghton must pass his job to a new leader who can build on his legacy. Curiously, the executives he has placed in the best position to take over are the very ones who marched Corning off the telecom cliff. One thing's for sure: He'll have to go outside the family because there are no willing heirs waiting in the wings. For a company that has looked to the Houghtons for leadership for most of its history, that's a worrisome prospect.

Houghton was groomed for his role from birth. As a child he would rise from his bed in the imposing family mansion known as The Knoll and look out his window at the Corning plant that stretched for blocks beneath him. At the dinner table, father Amory Houghton Sr.—the founder's great-grandson, who ran Corning for much of the '30s, '40s, and '50s—would lecture Jamie and his brother Amo on the rewards of investing "patient capital" in high-risk technologies. At the same time the boys learned to mix with Corning's workers by attending the same schools. Says his wife Maisie: "Corning isn't in his blood—it is his blood."

To be sure, Houghton eventually was sent off to prep school at St. Paul's in Concord, N.H., the same school attended by Democratic Presidential nominee John Kerry. Later he followed a long line of Houghtons to Harvard University; there's even a Houghton Library in Harvard Yard. Then, after a disastrous first year at Harvard Business School, he flirted with the idea of life beyond Corning and had a ball working at Goldman, Sachs & Co. But in 1962, after earning his

WEEKS Houghton gutted the business he ran—then promoted him



MBA and deciding he didn't want to spend the next 30 years on Wall Street, he joined Corning. He was promptly sent off to its lightbulb plant in Danville, Ky. Later he was stationed in Europe and helped lead Corning's push into global markets.

In 1983, at 47, Jamie succeeded Amo as CEO. "We were barely breaking even, and the cupboard was bare," he recalls. So he got out of the mature lightbulb ventures while pushing more promising businesses such as fiber and medical testing. "He has a great commercial nose," says Amo. During his 13-year term, Jamie more than tripled sales, to \$5.3 billion, and doubled return on equity, to 17%.

A CALL TO PUBLIC SERVICE

THEN IN 1993 a near-fatal accident seemed to reorder Houghton's priorities. He was hit by a car while walking through dimly lit Colonial Williamsburg after a meeting of the Business Council. Houghton spent weeks in the hospital. Three months later he showed up for a board meeting in a wheelchair. "He was pale and tired, yet showed great humor," recalls director Gordon Gund. Still, he could no longer play 6 handicap golf or downhill ski, and he still walks with a

R&D is 11% of sales—a strategic plus, but it sucks cash

cane. And beneath the brave front, "I'm sure coming that close to death changed him internally," says Amo.

In 1996, when he turned 60, Houghton told the board he'd had enough. Public service had always been part of the family creed. So, like his father, who served as Ambassador to France under President Dwight D. Eisenhower, and Amo, now a Republican member of Congress, Jamie was itching to make his mark beyond Corning. Houghton's handpicked successor as CEO, Roger Ackerman, quickly and radically reshaped Corning. He jettisoned the mature medical-testing and CorningWare consumer businesses while ramping up fiber capacity. Simultaneously he embarked on a strategy to make Corning a big player in the red-hot field of telecom photonics, which includes lasers and amplifiers to move light through fiber. Problem was, "we didn't invent all the keystone components in photonics, and that meant we didn't have the same type of competitive advantage we did in fiber," says Corning President Wendell P. Weeks.

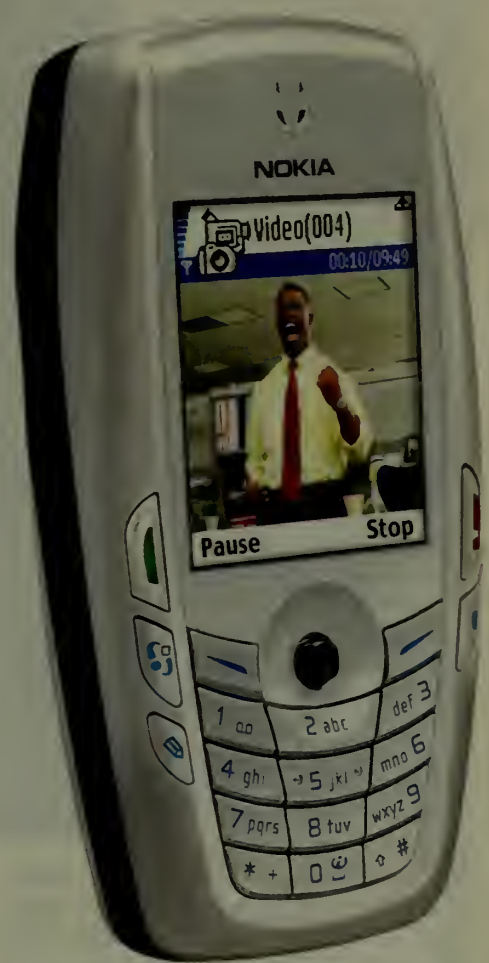
That forced Corning to acquire much of what it needed. In a little over a year it spent \$10 billion to buy 10 or so companies. Wall Street—deep in the grip of telecom fever—suddenly saw Corning through new eyes. In early 1999 "there wasn't a single telecom analyst covering Corning," recalls Katherine M. Dietz, then head of investor relations. But after Corning announced its first big photonics acquisition in late 1999, "our investor meetings were standing room only." In less than a year, the stock shot up from \$25 to \$113.

Ackerman ignored Wall Street's advice to dump the rest of Corning's nontelecom businesses, as well as pressure to pay \$4 billion to buy SDL, a maker of pump lasers. SDL was snapped up by JDS Uniphase instead, in a deal that later triggered one of the largest writeoffs in corporate history. Still, like many in the industry, Ackerman was exuberant. In 2000 he predicted that over the next four years telecom network



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Management Dynasties

would expand "17-fold in North America alone," a forecast that proved wildly inaccurate.

In January, 2001, Ackerman retired as CEO and handed the job to then-President Loose, a 36-year Corning veteran. No sooner had Loose taken charge than the bottom fell out of the market. As the year began, Corning predicted that its photonics sales would double, to \$1 billion. By April the forecast was trimmed to zero growth. In early July, with sales in freefall, Corning was forced to take a \$5.1 billion writeoff on its recent acquisitions.

The board was becoming increasingly uneasy. In June, when Ackerman retired as chairman, O'Connor asked Houghton—who had remained on the board since his retirement—to become nonexecutive chairman. But Loose was unable to stem a growing panic as the crisis deepened. "Concern over bankruptcy was on everyone's mind," says Dietz. By April, 2002, the board had seen enough and unanimously backed Houghton's return as CEO. Even Loose, who insists he wanted to retire because of a "personal issue," supported the change. "My goal in life was never to be CEO," he says now. "And I felt there was nobody better to lead this company than Jamie."

EXECS, CLEAN UP YOUR MESS

INWARDLY, HOUGHTON was fuming. "Someone has really screwed up," he recalls thinking. "So let's line everyone up against the wall and figure out which one you shoot." He was especially enraged at the damage to Corning's culture. "The

GLASS CEILING?
Corning insists it won't get ahead of demand for LCDs



company had been ripped apart in a lot of ways, and there was a lot of backbiting and very little teamwork," he says. And the arrogance of the telecom group had become insufferable. "The wave-guide guys [felt they] were king of the hill." Houghton's answer was to return to a team style of management. He immediately reconstituted the management committee structure he had used to govern Corning in his first term, composed of the top seven execs. "I told them we are going to be together all the time, and that 95% of what we decide, we decide together."

Problem was, Houghton would have to achieve this change with the same execu-

These days, Houghton is focused on revving up growth

tives who had served under Loose. With Corning such dire straits, recruiting stellar outsiders would have been difficult, if not impossible. He also knew that a company dominated by insiders, ax-wielding outsiders would have quickly alienated the workforce and caused some of his best people to leave. So rather than James Weeks, who had been in charge of Corning's optical-communications business, Houghton promoted him to president. "I need you to lead us out of this dilemma that helped lead us into," he said to the stunned executive. Similarly, he vaulted James Flaws, the CFO who helped negotiate the arrangement for billions of now nearly worthless photonics deals, to vice chairman.

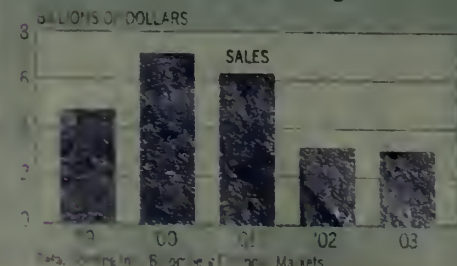
CORPORATE TRIAGE

HOUGHTON'S MOST urgent priority was simple survival. On CNBC, one cynic cracked that a "do not resuscitate order" should be placed on the stock. In July, Houghton proved an equity offering to raise \$500 million. To hedge funds it looked like a desperate ploy, and they heavily shorted the stock,

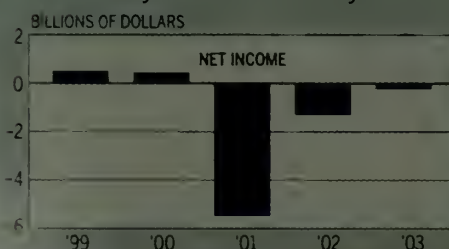
beating it down to \$1.50 from \$4 earlier in the month. That forced Corning to sue some 300 million shares to get \$100 million, heavily diluting the stock. The tide didn't turn until November, when Corning managed to sell its precision lens business—the world leader in making lens systems for rear-projection TVs—

CORNING'S ROLLER-COASTER RIDE

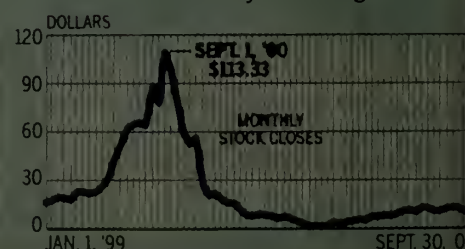
After a painful plunge, sales are stabilizing...



...and Corning is clawing its way back from the abyss...



...but the stock is still way off its high



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Management Dynasties

3M for \$850 million in cash. Although Loose had already announced deep layoffs, more were needed to stem the bleeding. Most were targeted at fiber and photonics. That fall, Houghton cut back to just one operating fiber plant, from five. Although those factories were far from upstate New York, the town of Corning also lost 3,500 high-paying jobs.

Because Houghton had continued to live on his sprawling 115-acre estate above the town after retiring in 1996, he was painfully aware of the impact. During the boom, Corning's housing market had exploded, and a subdivision sprouted near the company's research labs, with large homes averaging \$300,000—triple the average price in the area. Outside the Houghtons' offices on Market Street, every storefront was bustling. At the union hall, so many supposedly blue-collar workers had grown rich, at least on paper, that there were jokes about them sitting at a "millionaire's table."

After the crash, Market Street was lined with vacant storefronts. The high-end houses were abandoned in mid-hammer-stroke. And paper profits evaporated—in a town of true believers, virtually everyone rode the stock all the way down. Houghton insisted that the company go out of its way to help those being laid off. "It's very difficult for someone to walk down the street and get a job in Corning, N.Y.," he says. "There's nothing there." So the company gave most salaried workers at least five months' severance and offered extended insurance benefits, pushing the cost of layoffs to more than \$1 billion.

These days, Houghton is focused on revving up growth. Corning's most prom-

ising market is LCD glass, which is expected to surpass telecom as the company's largest business this year. Today, Corning and its Korean joint-venture partner, Samsung, control 58% of the world market for LCD glass, says Ross Young, CEO of researcher DisplaySearch in Austin, Tex.—and nearly three-quarters of the high-margin, largest-glass panels that are most desirable for making TVs. There is a chance that the biggest-screen TVs—those above 40 inches—will swing toward plasma and rear-projection technologies. But for now LCD remains dominant in smaller TVs, the bulk of the market.

A LIQUID-CRYSTAL BUBBLE?

WARY OF REPEATING their fiber debacle, Corning execs swear they're far more skeptical of the LCD boom. The company is conducting its own surveys of demand for flat-panel LCD TVs and flat-screen computer monitors to make sure it doesn't get ahead of real demand. Nonetheless, some experts worry that a "crystal bubble" is developing, with excess capacity and falling prices. DisplaySearch's Young cautions that flat-glass fabricators are rapidly boosting capacity without regard for overall market demand. In August such fears drove Corning's stock down \$2, or 17%. But Flaws insists Corning hasn't seen any slowdown and in early September predicted demand for its glass will surge 70% this year, higher than earlier expectations.

Corning's other big investments look

Ceramic filters must beat a tech challenge from Japan

more risky. Houghton believes the diesel-emissions market will explode in 2009 when tough new clean regulations take effect. says Corning's ceramic filter—similar to the substrate invented for catalytic converters in cars—could remove over 90% of the soot and other emissions from heavy-

diesel trucks. And he's betting that could double the company's \$400 million environmental business by 2009. But Corning must first beat out alternative technologies being developed by Japanese rivals.

The biggest problem for Corning is the fiber business remains flat on its heels, some 75% below its peak. "That will take the albatross," says John Slack, an analyst at Morningstar Inc. who has a "sell" recommendation on the stock. Even Corning now concedes that the premium-price fiber market won't be reviving anywhere near as soon as it had hoped. This pessimistic outlook forced Corning to announce the \$2.8 billion charge on October 1, including a writeoff of an expansion of a now-mothballed fiber plant in Concord, N.C. Houghton is banking that telecommunications companies eventually will spend heavily to bring fiber directly to homes and offices in order to provide super-high-speed Web, HDTV, and other broadband services. But for the near future, fiber will drag on Corning's results.

Perhaps the most daunting remaining challenge for Houghton, though, is to ensure that this time he leaves a successor who can carry out his vision. Houghton doesn't believe CEOs should give much advance notice of their retirement, and isn't saying when he'll step down. When the time comes, Weeks is the clear frontrunner. He may seem a surprising choice, but supporters are banking on him having learned from his brush with disaster. "It made him a better executive," says Vincent Dupont, an analyst at Alliance Capital Management LP, who owns Corning shares. Still, the boy looking Weeks is just 45 and clearly in a hurry to take charge. "Hopefully it will be for a while," he says.

When the time comes, it will mark the truest test of Jamie Houghton's remarkable return. His first retirement ended abruptly when a nonfamily member nearly took Corning over the edge. And this time, he won't be coming back. It will be up to outsiders to carry on the legacy of Jamie, Amo, and their ancestors. ■

—By William C. Symington
in Corning,

BIO

Jamie Houghton

A life of privilege and a devotion to family, community, and service

BORN Apr. 6, 1936, in Corning, N.Y.

FAMILY HISTORY Great-great-grandfather Amory Houghton Sr. founded Corning in 1851. Father, also named Amory Houghton Sr., ran the company, as did brother Amory Houghton Jr.

BOYHOOD Grew up in the family mansion on a hill overlooking Corning headquarters.

EDUCATION BA, history, Harvard

College, 1958; MBA, Harvard Business School, 1962.

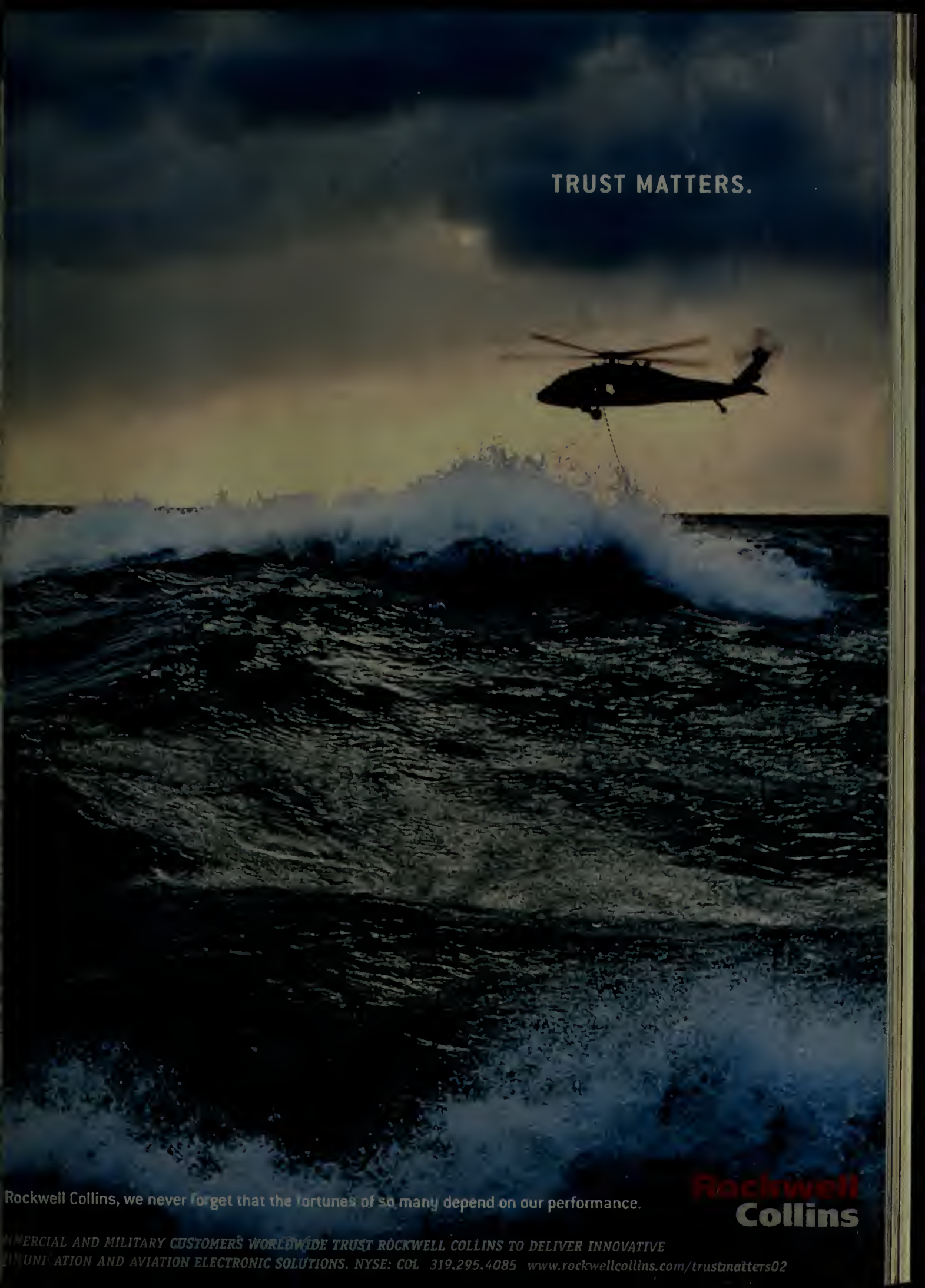
CAREER PATH Tried Goldman Sachs before joining Corning in 1962. Rose to CEO in 1983. Retired in 1996 but returned in 2002.

PUBLIC SERVICE Chairman of the Metropolitan Museum of Art in New York and senior fellow of The Harvard Corporation.

POLITICS A registered Republican. However, he held a fund-raiser at his home for U.S. Senator Hillary Clinton because of the work she has done for upstate New York.

FAMILY Met wife Maisie at Harvard; two grown children.



A dramatic photograph of a helicopter in silhouette, hoisting a person over a turbulent sea at sunset. The sky is dark and cloudy, with a bright orange glow on the horizon. The helicopter is positioned in the upper right, with a person suspended below it. The sea is dark and choppy, with white foam from the helicopter's wake visible.

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How to Market A Groundbreaker

Ford is pitching its gas-electric SUV to techies, as well as greenies

FOR JAMES FEAGINS, BUYING a new Ford Escape gas-electric hybrid SUV wasn't as much about saving pennies on fuel as it was about wanting to do his bit for clean air. "The environment is important to me," says the Fairfax (Va.) real estate agent, who picked up his \$30,000-plus, top-of-the-line, silver hybrid Escape on Sept. 30. With a job that requires a lot of stop-and-go driving, he's pleased that Escape's 33 mpg should at least double the fuel economy of his old Ford Explorer. But truth be told, he's most excited about the kick of driving the latest auto technology. "Guys like their toys," admits Feagins, 48. "I like technology."

Ford Motor Co. is counting on finding at least 20,000 buyers a year who feel the same way. And the auto maker hopes there will be many more as it rolls out additional hybrid vehicles in the next few years to meet demand and burnish its brand image. The success of Toyota Motor Corp.'s latest Prius sedan has proved that hybrids aren't a short-lived novelty like electric cars. And they aren't just for Birkenstock-shod tree-huggers anymore. These days, hybrid buyers are looking for a cool car without the gas-guzzler guilt. Auto makers see another new audience emerging: technology-obsessed men. And to reach these diverse audiences, Ford is pitching its hybrid in venues previously ignored, such as *Mother Jones* magazine, holistic health forums, as well as in science magazines and a national tour to attract techie fans like Feagins.

The Escape's hook: It's the first full-fledged hybrid SUV. More significant, it's aimed at buyers who are looking for the space, power, and rough-weather capability of an SUV that was missing from early

hybrid cars. "People don't want to sacrifice to drive a hybrid," says Brian Moody, road test editor at auto information Web site Edmunds.com Inc. "People are willing to do the right thing for the environment—as long as it's easy."

Convenience was a big factor in Feagins' hybrid Escape purchase. He says he wasn't tempted by earlier hybrid SUVs from Toyota and Honda. "I was waiting for an SUV," he says, with all-wheel drive for snowy days and room inside for a Doberman and dachshund.

HYBRIDS AHOY!

FORD'S HYBRID IS the opening salvo in a burst of new vehicles that use hybrid technology to deliver more power, convenience, and prestige, as well as economy. Indeed, any auto maker whose pipeline is seen as not just environmentally unfriendly but also as a technological laggard. Honda will launch a peppery accord sedan hybrid in December (2004), and Toyota plans two SUV hybrids for early 2005 that get V-8-style power with a V-6 engine. Ford's first hybrid passenger car, the Fusion, and the Mercury Mariner SUV should arrive in the next three years. General Motors Corp.'s



NEW TOYOTA
Feagins
for the
technology

Hawking the Hybrid

Ford has a very different sales pitch for the gas-electric version of its Escape SUV, aimed at well-read "opinion influencers" who keep up with the latest technology.

	CONVENTIONAL ESCAPE	HYBRID ESCAPE
PRINT ADVERTISING	People, Time, InStyle magazines	The New Yorker, Smithsonian, Organic Style magazines
TV AND PROMOTION	Splashy TV ads and product placement in <i>American Idol</i> and Fox's 24	No TV; grassroots marketing through gatherings such as the Mind, Body & Beyond Expo; tie-in with organic beverage bottler Honest Tea
DEMOGRAPHICS	Roughly 55% female; first-time SUV buyers	Majority male, greenies and geeks; most don't currently own a Ford

Data: Ford

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Marketing Product Launches

hybrid vehicles begin arriving in 2007.

So how popular will Ford's hybrid be? Its order bank is already "a few thousand," along with 70,000 requests for information. Even though the hybrid Escape starts at \$26,970—about \$3,400 more than the V-6-equipped conventional model—Ford expects to sell every one it makes. It had better: Toyota has a six-month-plus wait list. If the Escape doesn't stay oversold too, it could draw negative buzz.

To generate sunny word of mouth, Ford is trying to lure the "opinion influencer," the one who devours information about new technology and advises friends on purchases. "This is the guy you talk to when you want to buy a plasma-screen TV," says Escape marketer Sheri Shapiro. A hybrid is a natural fit for this crowd, says Edmunds' Moody: "It's the automotive equivalent of the iPod. You can show it off, but it's also practical."

A DIFFERENT KIND OF CUSTOMER

FORD BEGAN STUDYING potential buyers while its hybrid was still in development. Starting in 1999, marketers collected focus groups of environmentally conscious consumers as well as technology fans, then picked a handful who agreed to let Ford study them at home. Marketers spent a day of "ethnographic immersion" with these customers,

Shapiro says, studying their homes, the goods they purchased, their driving habits, leisure activities, and even home decor. As the launch neared, Ford closely monitored the opinions of consumers who flocked to its hybrid Web site. The result surprised many Ford executives, Shapiro says: "It's someone supermainstream, not the stereotype" of the die-hard environmentalist who was the early hybrid customer.

Ford was challenged because likely buyers of the hybrid Escape are much better educated, wealthier, and older than existing Escape owners. Eighty percent of hybrid customers are college graduates vs. 44% of existing Escape owners. Would-be hybrid owners earn \$20,000 more. They tend to be between 35 to 40 years old, vs. 25 to 35 for the standard Escape. And they are much more likely to live in an urban or major metropolitan suburban market.

How to reach these buyers? They watch 14% less television than the average consumer and aren't swayed by jingles, so no Escape hybrid TV ads. Instead, Ford created a data-rich Web site with a mileage calculator, videos, and elaborate schematics of how a hybrid

works. Because these consumers subscribe to four more magazines than the average, ads run in *Smithsonian*, *Scientific American*, and *National Geographic* magazines—where ads for the standard Escape wouldn't appear. And Ford's newly launched nine-city tour

drawing large numbers of techies who want to get one for a spin. Positive buzz among these drivers, especially on Internet bulletin boards and chat rooms, will make or break the Escape.

For the green crowd, Ford is promoting the hybrid sustainable-lifestyle conventions and gatherings such as the Mind, Body & Beyond Expo. It arranged a tour

with Honest Tea, a large bottler of organic beverages, and took hybrids to the Casa de la Pasa (Calif.) tomato festival. And in a show of bean-sprout solidarity, Ford told readers of a *New Yorker* advertorial that pro leader Mary Ann Wright is a longtime vegetarian, with 11 vegetarians on her team.

Back in the Fifties, the coolest new purchase was a swoopy-finned V-8. In the '90s, it was the biggest SUV. Could it be that one day soon drivers will be vying to have the greenest car on the block?

—By Kathleen Kerwin in Detroit

Ford is forgoing TV ads. Typical hybrid buyers aren't big viewers

BEYOND GREEN

Honda Goes After The Racing Crowd

Imagine drag-racing in the backyard in a hybrid car. Honda can.

The Japanese auto maker plans to take its gas-electric hybrid technology to a new crowd—to those who aspire to the e-smoking engine performance. On Dec. 3, Honda Motor Co. will sell a 255-hp Accord hybrid that gets 30 mpg in the city and 37 on the highway. The \$29,000 hybrid will be faster than the stock 240-hp Accord and it will get a 40%



2005 ACCORD
Hybrid owners can brag about pickup—and mpg

fuel economy boost for a \$2,000 premium. Says one Honda exec: "You can have your cake and eat it, too."

That pitch may work. The company's hybrid Civic is overshadowed by Toyota's Prius because it's slower and its buyers can't make a fashion statement with the drab looks of a Civic. When Honda sells the Accord, on the other hand, its marketers will brag about 0-to-60-mph acceleration (about 6.5 seconds) that's a second faster

than a regular Accord. That could draw even more attention to a hot-selling niche. "That's a smart way to do it," says AutoPacific Inc. Vice-President James N. Hall.

Indeed, bragging about 0-to-60 times will be a first for hybrid owners. If a fast and efficient Accord has enough allure, the hybrid market could get yet another turbocharge.

—By David Welch in Detroit

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Can Wonder Bread Rise Again?

Turnaround artists Bryan Marsal and Tony Alvarez aim to fix Interstate Bakeries

DRESSED IN A RUMPLED shirt and working on three hours of sleep, Antonio C. "Tony" Alvarez II is in overdrive. On Sept. 22, he was appointed CEO of bankrupt Interstate Bakeries Corp., famous for such iconic brands as Wonder bread and Twinkies. Since then, Alvarez, 56—who is co-chief executive of one of the country's biggest turnaround firms, Alvarez & Marsal LLC—has been at Interstate's Kansas City (Mo.) headquarters, parsing financial statements and pep-talking workers in a bid to save the company.

Back in A&M's Manhattan headquarters, his partner, Bryan P. Marsal, is resting. He's fresh off a stint as chief restructuring officer at HealthSouth Corp., the embattled Birmingham (Ala.)-based rehabilitation hospital chain that nearly sank into Chapter 11 last year after former CEO Richard M. Scrushy allegedly inflated earnings by \$2.7 billion. (Scrushy is contesting the charges.) Marsal, 53, spent 15 months rebuilding HealthSouth. He slashed 250 jobs. Then he sold assets such as Doctors Hospital in Coral Gables, Fla.—not to mention 10 planes and one helicopter from Scrushy's fleet—helping to pay down \$3.3 billion in debt. As a re-

BAKE SALE

At Interstate, Alvarez plans to slash costs

sult, HealthSouth expected to generate \$650 million in this year. Alvarez tends to work

same magic on Interstate as his partner did on HealthSouth. "We come to companies at their worst moments in life—we save them," says Alvarez.

Cocky and intense, Alvarez and Marsal have become Corporate America's favorite repairmen. The tag team's 21-old firm has helped salvage dozens of sinking companies, from watchmaker Timex Corp. to drugstore chain Pharmacia Inc. Their recipe, they say, is simple: relentlessly cut costs, hoard cash, and constantly communicate the minutest financial details and restructuring plans to creditors, so as to avoid any backsliding. Most important, they make quick and decisive decisions to resolve problems that company executives might waffle over for months—a brash approach that has sometimes gotten them into trouble.

UNAPPETIZING RECIPE

INTERSTATE COULD be one of A&M's biggest challenges. The nation's largest wholesale bakery refused to cut its overhead and therefore was unable to compete at bargain-basement prices that would have allowed it to push more aggressively into mass-market channels such as Wal-Mart and Target Stores Inc. It also botched a plan to restructure its Hostess cupcakes and I Can't Believe It's Not Dongs so that they would have a longer shelf life. They turned out doughy and unappetizing. By his first day on the job, Alvarez had helped persuade J.P. Morgan Chase & Co. to pony up \$200 million in new financing to keep Interstate's operations running. Interstate filed for bankruptcy protection the same day, weighed down in part by \$600 million in debt. Now Alvarez is planning to slash labor and production costs, while boosting distribution to Wal-Mart and other discount retailers.

The markets are confident so far: \$1 billion of Interstate bonds issued in August are still worth 85¢ on the dollar, solid, for a distressed company. "We're taking the approach he is taking," says Leonard A. Lauder, a former chairman of the Federal Reserve Bank of Atlanta and Interstate's director. "It isn't just total liquidation."

While Alvarez and Marsal have won plaudits from corporate boards, they have stirred up controversy. Competitors, especially, allege that A&M is prone to self-dealing, pointing to examples such as a deal with Enron Corp.'s accounting firm, Arthur Andersen. While Marsal is dismantling Andersen, A&M hired si-

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People Turnarounds

its former turnaround specialists. Although the new hires weren't involved in the Enron scandal, critics slammed A&M for helping itself to the assets of a bankrupt client, putting A&M's interests ahead of those of creditors and shareholders. Marsal contends that A&M bought out the employees' contracts with the blessing of Andersen's board.

PLAYING TOUGH

IT WASN'T THE FIRST time the partners were accused of being greedy. In 1996, Marsal crafted a plan for Vestar Capital Partners, a New York investment firm, to buy bankrupt apparel maker Bidermann Industries USA Inc. without a public auction. Under the deal, Marsal, already Bidermann's CEO, would have kept the top job for three years, and A&M would have received an equity stake. The court disapproved. "Mr. Marsal has abandoned the debtors' interest in order to advance his own personal wealth," wrote Tina L. Bozman, chief judge of the U.S. Bankruptcy Court in the Southern District of New York. The slap led Alvarez and Marsal to institute a rule barring the firm from investing in client companies or funds that might seek to buy those companies.

Still, A&M can play tough with clients and their creditors. Marsal and HealthSouth execs sued Michael J. Embler, a distressed debt investor with Franklin Mutual Advisers LLC, for declaring

HealthSouth in default and demanding accelerated bond payments. The case ultimately was settled out of court. "Some people call me a bull," Marsal says. "I just go straight ahead." Embler did not respond to requests for comment.

Alvarez and Marsal honed their take-no-prisoners approach while working as in-house Mr. Fix-Its. Alvarez once ran the restructuring practice at accounting firm Coopers & Lybrand, while Marsal worked in Citibank's bad-loan unit. They met as finance executives at former consumer-goods conglomerate Norton Simon Inc. in the early 1980s. During a round of golf, they decided they should offer an alternative to the legions of consultants who got bogged down in details and were afraid to radically change the companies they were trying to save. "It's better to make a decision, be 10% wrong and 90% right, than not to address the problem," Marsal says. Soon after, they founded their firm based on that philosophy. A&M now has more than 300 employees, each of whom generates \$500,000 to \$700,000 in annual revenue, Marsal says. The total payoff can be huge for the firm: HealthSouth has paid A&M \$24 million so far.

MARSAL
HealthSouth
paid A&M
\$24 million



A&M often also receives "success fees generally calculated based on the rise in company's value over a set period of time."

Alvarez and Marsal have riches and notoriety to spare, but family is their biggest passion. Alvarez, who was born in the Philippines, was married at 17. He and his wife, Abigail, immigrated to the U.S. in 1969 and settled in New York. Today three of Alvarez' sons work at A&M. "We're very, very tight-knit, sort of clan-

BIOS

Antonio C. Alvarez II Bryan P. Marsal

The two have become Corporate America's favorite repairmen:

BORN Alvarez on Aug. 10, 1948, in Manila; Marsal on Mar. 26, 1951, in New Orleans

EDUCATION Alvarez: BS, commerce, De La Salle College in the Philippines, 1965; MBA, New York University, 1974. Marsal: BA, business, 1973, and MBA, University of Michigan, 1975.

CURRENT POSITION They are co-chief executives and managing directors, Alvarez & Marsal LLC.

CAREER PATH Alvarez ran the corporate restructuring unit of accounting firm Coopers & Lybrand

before becoming vice-president for finance at former consumer goods conglomerate Norton Simon Inc. in 1981. There he met Simon's director of operations, Marsal, who had worked at Citibank's Institutional Recovery Management unit. They launched their turnaround firm in 1983.

MAJOR COUP In September, during his first week on the job, Alvarez secured \$200 million in new financing for bankrupt Interstate Bakeries, maker of such treats as Twinkies.

OFF HOURS Marsal studies history, especially Henry Clay, "the Great Compromiser."

FAMILY Alvarez married Abigail when both were 17; they have four children and five grandchildren. Marsal is married to Kathleen, with two children.

nish," says Antonio M. Alvarez III, 38, who runs A&M's European business. Marsal, a six-foot-four former high school football player who was raised in Detroit, is often on the road like his partner but is determined to return home on weekends to attend PT meetings and his two children's soccer games.

The duo continues to score juicy projects. As they have designs on airline industries, such as airline. It's not yet clear if A&M will score another win at Interstate. But if it does, Alvarez says he knows how he will celebrate with Marsal and their comrades: with a batch of Twinkies. ■

—By Brian Grow in Atlanta



BRYAN MARSAL



TONY ALVAREZ

BusinessWeek online

For interviews with A&M's CEO's, go to businessweek.com/magazine/extra.htm

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COMMENTARY

BY PAUL MAGNUSSON

Stalking Deer Hunter Dads

Why Kerry's attempts to woo gun owners are missing the mark so far

VAN KNUTSON SEEMS like the kind of guy who'll be voting Democratic on Nov. 2. The beefy middle-school teacher from Sturtevant, Wis., is a member of the National Education Assn., the union that sent more delegates to the Democratic National Convention than any other. He's no great fan of the Administration's education policy, either. But

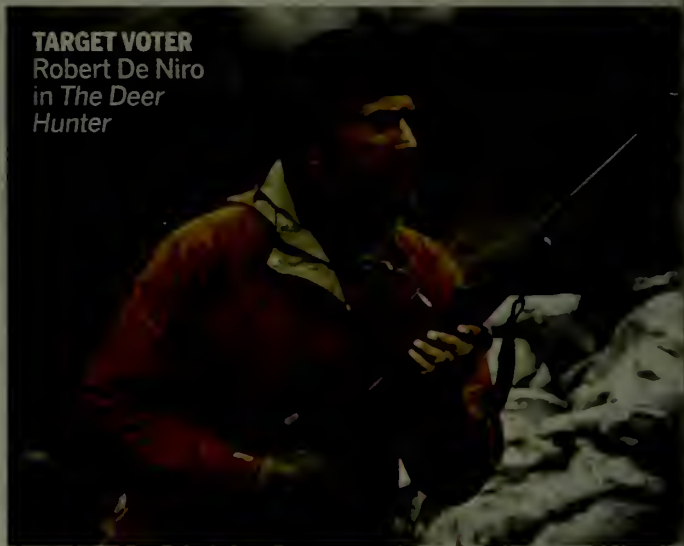
come November, Knutson, 48, will be casting his ballot for George W. Bush. The President seems like the genuine article, says Knutson, while John Kerry comes off as a phony. What really frosts Knutson, who with his brother, Todd, owns 13 guns, including a Thompson submachine gun, are news photos of Kerry "parading about" in blaze orange carrying a shotgun.

Hunting is a near-religion in rural areas of Wisconsin, as well as the battleground states of Pennsylvania, Ohio, Michigan, West Virginia, and Minnesota, where the opening day of deer season is a semi-official school and factory holiday. And at least judging from "Deer Hunter Dads" in the Badger State and a poll in Pennsylvania, Kerry is doing almost as badly with the gun vote as Al Gore did in 2000.

United Auto Workers member John Fredricks, 48, sums up the distaste that the rod and gun club set have for Kerry and the kindred feelings they have for Bush. Waiting patiently for Bush to arrive at a Janesville (Wis.) campaign stop, Fredricks explains: "Kerry has voted 50 times against the Second Amendment and then he goes out and has a photo op at some game preserve." As for the President, "He seems like the kind of guy you can sit down and have a beer with," says Fredricks. "He doesn't have five mansions—he has a ranch, and from the looks of it, it needs some work."

Indeed, despite statements supporting gun ownership, Senator Kerry has consistently voted for gun controls. That has led to "F" ratings from the National Rifle Assn. and Gun Owners of America and an endorsement from the Brady Campaign to Prevent Gun Violence. The Coalition to Stop Gun Violence gives Kerry a 100% rating, citing his votes against civil immunity for gun manufacturers, for background checks for private sales at gun shows, and for expanded restrictions on assault weapons and large-capacity magazines—

TARGET VOTER
Robert De Niro
in *The Deer Hunter*



votes that gun owners in Wisconsin can recite from memory.

Polls bear out the hunters' aversion to Kerry. A Sept. 17 K stone Poll shows Bush leading in Pennsylvania by 66%-27% among gun owners. Kerry is ahead 53%-39% among the un-armed. With so many gun owners in the state, Bush enjoys a slim overall lead. "This state is just inundated with NRA members, and their support [for Bush] is deep and strong," says Terry Madonna, the survey's director. A nationwide Zogby poll of gun owners last December shows they voted Bush over Gore 65%-26%, while Gore won over nonowners by a slimmer margin of 48%-39%. Gore's enthusiasm for gun control is blamed for his loss of usually Democratic West Virginia.

Elsewhere, gun ownership—and tolerance for firearms—is on the rise. Nationwide, between 43% and 48% of adults live in households with guns, according to recent polls. Not surprisingly, as gun ownership rose above 200 million weapons in some 90 million households during the 1990s, support for gun control fell steadily. Since 2000, support has dropped from 67% to 57%. An outright ban on handguns was opposed by 62% of Americans in a 2000 poll, up from 50% in 1987.

Kerry hasn't exactly come across as John the Deerslayer. In Wisconsin, he said in an interview that he likes to "crawl around on my stomach," stalking deer with his double-barrel 12-gauge shotgun. Wisconsin hunters, who shoot deer with rifles from a blind or tree stand, found Kerry's a curious and unlikely technique. And the Kerry campaign responded to an *O' the Life* magazine query recently by saying that Kerry's favori

Among gun owners in Pennsylvania, Bush leads one poll by 66%-27%

n is a "Chinese assault rifle." After it
s pointed out that private ownership of
automatic assault rifle without a \$750
eral permit is a felony, the campaign
ckly retracted the statement, insisting
favorite rifle was actually a bolt-ac-
n, 100-year-old "relic" from Russia.
Mick Beatovic, co-owner of Badger
tdoors Inc., a West Milwaukee (Wis.)
ooting range and gun store, says a cus-
mer came in recently demanding to
ow who had a car outside with a "Ker-
or President" bumper sticker. The of-
ding party owned up and quickly left
id angry mumbling.

Bush has an advantage, of course, in
having a 20-year Senate voting
ord to nitpick. This allows the Presi-
nt to have it both ways: He vows that
would have signed an extension of the
ault weapons ban when it expired in
ptember, but not a peep was heard
n the White House when no bill ap-
ared on his desk. Meanwhile, Kerry has
shed noisily for a renewal.

Bush also has a positive message, says
ris Winkler, a member of Sportsmen
Bush in Caledonia, Wis. Winkler, a 35-
r-old independent, praises the Admin-
ation for seeking to increase access for
nters to public lands. "It's getting
der and harder to even find a place to
nt, so public access is a big issue," he
s. That also means more snowmobiles
l all-terrain vehicles allowed into oth-
ise inaccessible lands—an idea op-
ed by environmental groups but fa-
ed by hunters, who need a way to haul
-lb. deer carcasses out of the woods.

Kerry may be getting the message, fi-
y. His campaign has issued a "sports-
n bill of rights" that supports private
ership of rifles and shotguns, includ-
semiautomatics (without mentioning
dguns). He also backs programs to
st access to private lands for hunters
l fishermen, as well as protections for
lands and wildlife habitat. On Sept. 27,
told a Spring Green (Wis.) audience:
now hunting is valued up here in Wis-
sin. You're going to hear them try to
g up on me on guns.... The truth is,
a gun owner. I'm a hunter. I've hunt-
since I was 12, 13 years old."

No matter. NRA Executive Vice-Presi-
t Wayne LaPierre says he's going to
ke Kerry's voting record the issue with
"intense" ad blizzard, including 30-
ute TV infomercials and mailings
ed at 50,000 gun and fishing clubs.
e spot that began airing on Oct. 4 fea-
es a poodle wearing a "Kerry" sweater
a pink bow. The voiceover intones:
at dog don't hunt." ■

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Dragging Heels, Canceling Deals

Skittish investors and execs are making mergers harder to pull off than ever

IT WAS THE KIND OF DEAL THAT would once have been wrapped up in the blink of an eye. In May, real estate investment company Elden Holding Group LLC signed a letter of intent to buy one of its affiliate's customers—Earl Scheib Inc., an auto paint and repair chain based in Sherman Oaks, Calif.—for \$17 million. But four months later the deal was dead. Scheib backed out because it lost patience with how long Elden was taking to go over its books. Christian K. Bement, chief executive of Scheib, says: “It was almost as if [Elden] was afraid.” Elden declined to comment.

The ditched deal is yet another sign of the funk clouding one of Wall Street's most profitable businesses: advising on mergers. After doing 19% more deals in the first quarter worth more than double those announced in the same quarter of 2003, Corporate America is losing momentum. In September, companies unveiled deals worth \$29 billion, half as much as in the same month in 2003, according to Thomson Financial.

This stubborn soft patch in deals is frustrating major firms on the Street. Many expected a burst of mergers to help their earnings this year, but it hasn't happened. “Mergers and acquisitions have yet to really get off the ground,” says Richard Strauss, financial-services analyst at Deutsche Bank. Now many bankers are setting their sights on next year.

Even when deals come back, some bankers say, they probably won't be the

gold mine they were at their peak in 2000. Because of corporate-governance reforms, executives and board members have become much tougher shoppers. So bankers are having to work longer and harder on deals, only to see more of them abandoned. Says Jack Levy, head of M&A at Goldman, Sachs & Co.: “Executives pay a lot of attention to valuation and due diligence. That state of mind is not going to change.”

Already some 28% of the deals announced this year have bitten the dust or are still pending, the highest percentage since 1996, according to Thomson. Sixteen months and one PeopleSoft CEO later, Oracle Corp's \$6.6 billion bid for the software maker is still in limbo. On Oct. 5, one board member said the company is still willing to entertain a bid from Oracle, but only “at the right price.”

A SKITTISH STOCK MARKET

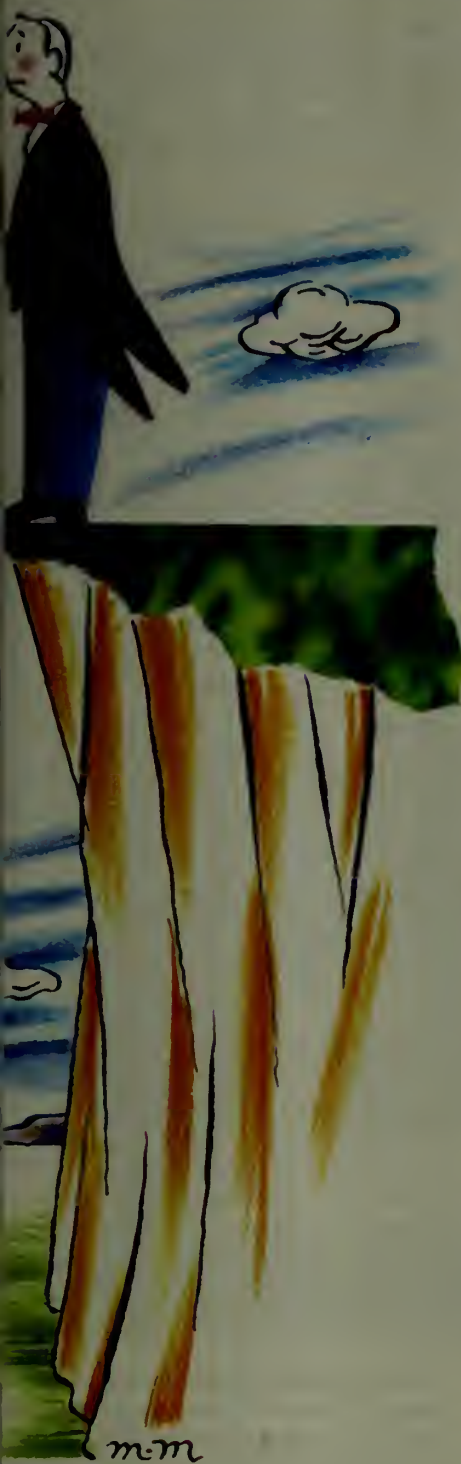
BANKERS ARE TRAPPED between buyers and sellers who are fussier than ever. Although the nonfinancial companies in the Standard & Poor's 500-stock index hold close to \$700 billion in cash and short-term investments, many corporate buyers are sidelined, waiting for the uncertainty reflected in a skittish stock market to dissipate. Meanwhile, shareholders are pressuring companies not to gamble away the cash they have on deals. Instead, they want companies to buy back stock, thus pushing up share prices, or to start paying dividends.

Investors and executives are taking far longer to get back in the groove than

**Shareholders
would
rather have
companies
buy back
stock**

their investment bankers hoped. Soon they are backing out of deals once they discover that a takeover target's management is being reshuffled or that the company faces a regulatory probe or lawsuit. On Sept. 21, Leawood (Kan.) based Gold Banc Corp. announced that proposed settlement of a lawsuit against the company could throw a wrench in its plans to be acquired by an investment group through Silver Acquisition Corp. Silver asserts that the settlement could damage the bank's financials, which Gold Banc disputes, according to Gold Banc's news release.





Some buyers are avoiding companies that miss their numbers. Carver Bancorp wants to discuss paying less for Independence Federal Savings Bank since, it says, the bank's "financial circumstances" have deteriorated since March, when the two agreed to merge. IFSB rejects Carver's assertions.

Other companies may have troubles as commodity prices rise. Already more than half the companies in the S&P 500 have issued earnings warnings in the third quarter. "Higher raw-material prices will have more bad effects on their margins," says Jack Maier, managing

partner at New York financial advisory firm Legacy Partners Group LLC.

Meantime, the stakes for companies that make deals are rising. Executives say holdups due to regulatory hurdles could hurt their stock prices. "Who wants to have an overhang on their stock for 18 months?" asks SBC Communications Inc. CEO Edward E. Whitacre Jr., who is still upset that it took that long to win regulatory approval to buy Ameritech in 1999.

In fact, businesses are seeing their stocks hammered for deals that don't happen as well as for those that do. For example, the stock prices of Comcast and Vodafone Group have still not recovered to the levels at which they traded before their failed bids for Walt Disney and AT&T Wireless, respectively, in February.

LENGTHY DISSECTIONS

BUYERS AND SELLERS are also haggling over price. "With the perceived margin for error so small, deals are breaking up over as little as 5% differences in price," says Spencer D. Klein, global head of M&A for Chicago law firm McDermott Will & Emery LLP. On Sept. 3 retail software maker QRS Corp. broke off a deal to be acquired by JDA Software Group after the bidder's share price fell—axing the value of the \$107 million all-stock transaction by \$26 million. Instead, QRS will be bought by privately held Alpharetta (Ga.)-based Internet business-services provider Inovia International Inc. for \$114 million in cash.

Corporate-governance reforms are changing the dynamics of dealmaking, too. Board members, worried about personal liability if deals go wrong, are dissecting potential takeover targets for as long as six months before any announcement is made, lawyers say. Directors are routinely ordering up management background checks, which they did less often before. And where directors used to look over any outstanding litigation that a target might face, some are now hiring private investigators to interview potential witnesses to assess how costly the lawsuits might be. "In the past, some directors may

have looked at deals with the same level of focus as [they have] watching television at 10 p.m.," says Robert A. Profusek, a partner at law firm Jones Day in New York. "Now they're much more engaged."

Dealmaking involves so much consensus-building now that it's spurring new cottage industries. So many bankers, executives, consultants, accountants, and lawyers doing due diligence want to review documents related to deals that New York-based Intralinks Inc. has made a business of providing them with online data rooms. Participants can log in to see relevant materials. Intralinks says the average number of people who tap in to view each deal has soared to 155 in the third quarter of 2004, up from 75 in the first half of 2003. In one recent session, a record 510 people participated.

Lengthy auctions are fast becoming the new standard. Board members and execs at target companies like them because they can more easily document their efforts to get the best price for shareholders. Many buyers will do big deals only if they

share the risks by joining others to make bids, a process that usually takes longer than a solo effort. Comcast teamed with Sony Corp. and several private equity firms to buy Metro-Goldwyn-Mayer Inc. for \$5 billion in September. "Companies stretching to do larger deals are more often partnering with private equity firms," says Stefan Selig, vice-chairman of Banc of America Securities.

Even with such new tactics, the total value of deals this year is expected to stay stuck at less than half the \$1.7 trillion at the 2000 peak. And as the economy and stock market improve, it's far from certain that companies will become big spenders again in a hurry. Some

may just go it alone for a stretch. In Earl Scheib's case, the board pulled the plug in part because the company was starting to turn around after painful restructuring. CEO Bement says Scheib wanted to see how it would fare on its own for a while. At the least, Scheib may fetch a better price if it is put in play again. ■

—By Emily Thornton, with Roger O. Crockett, in New York

Putting the Brakes on Linkups

Here's why companies are increasingly reluctant to do deals:

HIGHER RISK Many potential targets are facing management changes, regulatory probes, or both

STIFFER PRICE FOR FAILURE Investors are punishing the stocks of companies even for deals that don't happen

GREATER PERSONAL LIABILITY In the wake of Sarbanes-Oxley and other reforms, directors and executives feel they're on the hook for their decisions

Data: BusinessWeek

Pretty Liberal With the Cash

Ron Burkle puts his celeb Rolodex to work for a social agenda—and CalPERS

WHAT DO RAP MUSIC impresario Sean “Puff Daddy” Combs and former Vice-President Al Gore have in common? Los Angeles money manager Ronald W. Burkle backed each of them with cash from the California Public Employees’ Retirement System.

Nobody cultivates the rich and famous quite the way Burkle does. The 51-year-old billionaire frequently hosts celebrity-packed charity events at his Beverly Hills estate. He has given millions of dollars to

political causes, most of them connected with the Democratic Party. Even former President Bill Clinton is on his team, serving as a senior adviser to Burkle’s investment firm, Yucaipa Cos., in return for a slice of the profits. But can Burkle turn his A-list Rolodex into high-powered returns for California pensioners?

In the past three years, CalPERS has committed up to \$760 million to

Burkle for investments that aim to help underserved segments of society while, of course, still making money for the retirement fund. He has been putting the money to work in a string of deals that he says will benefit minorities, women, and blue-collar workers. Last year, Burkle invested an undisclosed amount in Sean John, the urban-sportswear company founded by Combs. In May, he was one of the backers of Gore’s planned \$75 million cable-TV station, INDTV, which aims to provide



Eclectic Mix

Financier Ronald Burkle has been investing California state pension money earmarked for underserved segments of society into some surprising deals

SEAN JOHN A minority stake in rap impresario Sean “Puff Daddy” Combs’s urban sportswear company based in New York

TDS LOGISTICS A Canadian auto-parts company purchased in August, the month after it had been hit by a strike

INDTV Al Gore’s planned cable-TV station, which would be aimed at young viewers and based in San Francisco

news and entertainment for 18-to-3-year-olds. And in August, he paid \$30 million—some of it CalPERS money—to buy TDS Logistics Inc., a Canadian auto-parts concern that had been hit by a strike the month before.

Burkle argues that the Combs and Gore deals not only reflect his social mission but are also good commercial investments. Combs’s apparel business, he says, is one of the nation’s fastest-growing companies, reaching nearly half a billion in sales in just six years. With Gore, Burkle says he was able to invest in a cable station—currently running Canadian news—at a very low price because cable operators had yet to renew their subscriptions. After Gore laid out his business plan, the cable operators quickly re-upped. Burkle says both companies employ minorities and women and are creating jobs in urban areas. In the case

TIMES SQUARE Sales of Combs’s clothes are sizzling

of TDS, Burkle brought in a Yucaipa labor-relations specialist to help settle the strike, which resulted in wage increase adjustments in workers’ shifts, and commitment from the management to resolve several workplace issues. “We’ve gotten great returns by treating people well,” Burkle says.

FOOD FOR THOUGHT

THE SON OF A grocery-store manager, Burkle made a fortune in the 1980s and ’90s buying and selling supermarket chains such as Ralphs Grocery Co. and Dominick’s Finer Foods Inc. He says the rewards of socially conscious investing outweigh the risks. After the 1991 riots in Los Angeles, for example, Burkle says he spent \$50 million to rebuild damaged stores and keep workers employed. Those stores were later part of a 1992 merger between Fred Meyer Inc. and Kroger Cos. that netted Burkle \$1 billion. In choosing him to manage money in May, 2001, CalPERS said Burkle had earned an average annual return of 45% over the preceding 13 years. How much CalPERS makes won’t be known until the investments are sold in a few years.

The money committed to Burkle is small part of CalPERS’ portfolio. The nation’s largest pension fund, with \$16 billion in assets, CalPERS provides health-care and retirement benefits to 1.1 million current and former government employees in California. Three years ago, it began a big push into socially responsible investing. Burkle was one of advisers chosen from among 67 who ap



BURKLE Backing Al Gore’s TV venture



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plied to manage this money. He got \$200 million to invest in capital-starved urban and rural markets. A year later, CalPERS committed as much as \$560 million more for Burkle to invest in companies managed in ways that don't hurt labor.

Burkle's deals also illustrate how the line between business, social connections, and politics can be blurred as pension funds come under increasing pressure from labor unions, politicians, and activists to pursue goals other than simply making money. Gore has said that his new network will not espouse any particular political beliefs. But the deal was brought to Burkle by San Francisco venture capitalist Richard Blum, another INdTV investor, whose wife is Democratic Senator Dianne Feinstein.

Burkle says he and Combs have been friends for about eight years—since their meeting at a party at Burkle's house. Combs recently entered the political fray, starting a get-out-the-vote drive with the slogan, "Vote or Die!"

PARTY ANIMALS?

THESE RELATIONSHIPS strike some observers of the pension-fund world as just a little too cozy. "We should be concerned as taxpayers," says Stephen M. Bainbridge, a professor of law at the University of California at Los Angeles. "I don't want them making investment decisions so they can get invited to Puff Daddy's next party or advance their political agendas."

CalPERS declines to comment, but Burkle says that is certainly not the case. And he says winning his contracts from CalPERS was equally above board. He says he never has used his connections to influence the awarding of state money-management contracts. Still, he told *BusinessWeek*, he will no longer contribute to the campaigns of the California governor, state treasurer, or controller while he pursues new business with CalPERS. Since 1999, Burkle has contributed more than \$600,000 to campaigns for state office.

His focus, he says, is entirely on making money for California's pension system and bettering life for those less fortunate than him. "If I want to live in this big house, I have to feel good about myself," he says, sitting in the living room of his 32,000-square-foot mansion while a white-coated attendant serves him cranberry juice. California taxpayers better hope so. ■

—By Christopher Palmeri
in Los Angeles

The New Face of Venture Capital

VC firms now prize dealmakers with experience—not newly minted MBAs

IT WAS LIKE A RERUN OF THE heady days of the late '90s. In March, more than 70 venture capitalists from around the U.S. were fighting for a piece of CipherTrust Inc., an e-mail security startup outside Atlanta. Partners from one well-heeled VC firm without an appointment even camped out in the company's lobby, hoping to button-hole an exec. So when it came time to decide whose money to take and which investor to add to its board, CipherTrust could have chosen any number of veteran VCs. But it picked Asheem Chandna instead.

Asheem who? If the name doesn't ring a bell, you're forgiven. The 40-year-old had begun his career as a VC at San Mateo (Calif.)-based Greylock just six months earlier, after seven years as an executive at Check Point Software Technologies Ltd. He's one of a new breed of VCs who are arriving at the top firms after logging in years as high-tech execs, entrepreneurs, or apprentice VCs. "The days of bringing an investment-banking analyst into the firm have gone by the wayside," says Dave Barry, managing

editor of *Dow Jones Private Equity Analyst*, an industry newsletter. Gone, then, are the newly minted MBA graduates who start as partners.

These VC newcomers are part of a sweeping turnover in venture-capital personnel. Just in the past year, Kleiner Perkins Caufield & Byers, Benchmark Capital, and Sevin Rosen Funds have revamped their partnerships. Since 2000, Battery Ventures, a star of the late-'90s telecom boom based near Boston, shed four general partners and promoted four associates to replace them. Batterycrosstown rival, Charles River Ventures, has lost three partners and added four

'THE 3 A.M. SWEATS'

FIRMS OFTEN CHANGE partners when they raise money for a new fund. But the game of musical chairs is picking up faster than usual. Roughly half of the firms are soliciting funds, twice as many as usual, says Steve Baloff, a partner at Advanced Technology Ventures in Menlo Park, Calif. That's because firms wait out the bear market before going back to investors last year when the stock market started to rise.



LESS IS MORE
Tai invests in small teams that win sales frugally



SEASONED
Battery's Lee relies on his years as an entrepreneur

The turnover at established firms has bred new competitors. Last year, Ter-Garnett and David Helfrich left Venek Associates and ComVentures, respectively, to form Garnett & Helfrich Capital. As they raised their first fund, they found themselves competing with their former firms for two investors: Harvard and Stanford universities. In the end, each school invested with the new firm instead of the established ones, Garnett & Helfrich. Harvard and Stanford declined to comment on their choice.

With so much money now chasing so many good deals, VC firms are seeking new partners who can bond with company founders. There's as much as \$80 billion of uninvested venture capital available, and the industry is on track to invest just \$10 billion this year. "Because the business is tougher today, an individual's ability to identify with the entrepreneurs is very important," says Rick Frisbie, founder of Battery Ventures, which promoted an entrepreneur, Roger Lee, to partner in July.

Lee cut his teeth at Corio Inc., a computer-services provider he co-founded, before joining Battery in 2001. "I rely on my experience as an entrepreneur," he says. "I've paid payroll out of my back pocket, and I've had the 3 a.m. meetings." That background helped Lee win his first deal at Battery. Together with partner Mark Sherman, Lee pursued an investment in security appliance maker Neoteris, which was raising \$17.5

million last year. "Because [Roger] has been an entrepreneur, he can relate to you as an entrepreneur," says Krishna Kolluri, Neoteris' founder. Battery was the only new investor invited to contribute funds. Then, in December, NetScreen Technologies bought the company for \$265 million.

Another newcomer at an established firm is Bill Tai, who joined Charles River to head its Silicon Valley office two years ago and exemplifies the new style of venture investing. In the wake of the technology-stock meltdown, Charles River decided to slash its \$1.2 billion fund to \$450

million and bid farewell to all but one partner at its California outpost. With a smaller investment pool, the firm needed someone who understood that less is more. "My model has always been to invest in three- or four-person teams" at low valuations, Tai says. "That was anachronistic in the bubble." Since joining Charles River, he has made five investments in wireless, software, and semiconductor startups valued at an average of \$5.7 million each before he funded them. The startups' common theme: an ability to win customers without having to spend gobs of money.

At 42, Tai is an elder statesman among the new hires. Previously, at Institutional Venture Partners in Menlo Park, Calif., he funded chipmaker Transmeta Corp. of Santa Clara, Calif. The company had a spectacular initial public offering in 2000—

rising 67% to close at \$35 a share on its first day of trading—but has since seen its shares fall below \$2 apiece. The experience steeled him for his job at Charles River. "The firm was looking for someone who had experience throughout the cycles in venture capital, including the tougher prebubble era," Tai says. "They recognized that we may be back in that kind of environment for some time." Certainly the firms that succeed in this environment will be the ones that choose their next generation of leaders carefully. ■

—By Justin Hibbard
in San Mateo, Calif.

Changes In The Lineup

A new generation of venture capitalists is moving to center stage in Silicon Valley

THE ENTREPRENEUR

Roger Lee
Battery Ventures

Co-founded computer-services outfit Corio before joining Battery in December, 2001. Promoted to partner in July

RECENT DEAL Helped Battery win some funding for Neoteris, which makes Internet security devices

THE EXECUTIVE

Asheem Chandna
Greylock

Spent seven years as an exec at Internet security company Check Point Software Technologies. Joined Greylock last year

RECENT DEAL Beat back rivals to capture a stake for the firm in CipherTrust, an e-mail security company

THE VETERAN VC

Bill Tai
Charles River Ventures

Cut his teeth at WaldenVC and Institutional Venture Partners. In 2002 signed on to run Charles River's Silicon Valley office

RECENT DEAL Ensured Charles River invested in wireless chip designer Staccato Communications



Hate Your Software? Write Your Own

JotSpot's wiki service lets the minimally tech-savvy create just what they need

IF THERE'S ONE THING TECHNOLOGY does best, it's freeing the masses from the tyranny of experts. Word processors made us all our own typists. Spreadsheets wrested the power of financial analysis from the green-eyeshade guys. Then the World Wide Web enabled thousands of people who never ran a physical store to make a living as merchants on eBay Inc.'s global marketplace.

One job has remained the exclusive province of about 2 million tech wizards, however: writing software. As a result, software programs always seem hard to

learn and even harder to customize to our particular needs.

Now a new startup aims to bust open the arcane world of software creation. On Oct. 6, JotSpot Inc. in Palo Alto, Calif., introduced a Web service that it hopes will enable some 10 million minimally tech-savvy people—those who know their way around a spreadsheet program—to quickly write simple, customized Web programs for managing customer support, tracking job candidates, and the like. Think of it as do-it-yourself software. “Just as eBay empowers the part-time seller, we want to

NEW SPACE Spencer and Kraus were founders of the Web portal Excite

empower part-time programmers,” says JotSpot Chief Executive Joe Kraus

“We’ve lowered the energy and skill level required to create an application.”

How? JotSpot, founded by Kraus and Graham Spencer, two founders of the Web portal Excite, is harnessing the power of Web software called wikis. Named after the Hawaiian word for “quick,” wikis are collaborative Web sites. Users can create one in a snap and invite anyone else to edit it or add material. They’ve rapidly spread as quick-and-dirty online scratch pads among small corporate groups at companies such as Walt Disney and SAP. But after they started to use wikis themselves, Kraus and Spencer quickly realized that the software could be much more: a foundation to create simple Web programs nearly as easily as it is to create wiki Web sites themselves.

FILLING A GAP

BACKED WITH \$5.2 MILLION from venture-capital firms Mayfield and Redpoint Ventures, JotSpot has created wiki software that lets people assemble, Lego-style, basic forms such as mailing lists and calendars. With JotSpot’s wiki tools, people can also create their own applications that draw on the power of the Web. With a few keystrokes, data and services from other Web sites can be automatically tapped and deposited on the wiki. For instance, a custom wiki program to keep track of prospective customers could tap financial data from Hoover’s, stories from Yahoo! News, and search results from Google, providing a quick picture of each customer’s needs. The software also lets people send e-mails to a wiki page, which will automatically organize the information in the message.

Still, with thousands of different programs out there, why would anyone need more? Because a wide gulf remains between what traditional enterprise software does and the way people actually work, notes Mayfield managing director Allen Morgan. Software from the likes of SAP, PeopleSoft, and Siebel Systems to manage customers and corporate resources has a lot of bells and whistles, but it can be costly, complex, and inflexible. Users often must alter their work to fit the programs, which discourages many from using them. As a result, people often fallback on e-mail, which has its own problems: It requires endless exchanges and strands valuable information inside it.

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Information Technology Software

boxes. "There's this in-between space that wikis can fill," says David Ornstein, a lead program manager on Microsoft Corp.'s Windows team and author of its own wiki software, FlexWiki.

Microsoft's presence is just one clue that JotSpot faces some potent competition. Users of wiki rivals such as Socialtext Inc. in Palo Alto and the open-source program TWiki are already creating custom Web applications. And collaboration

software, such as IBM's Lotus Notes, Groove Networks' Virtual Office, and Microsoft's own SharePoint, could be tweaked to allow people to add customized programs. "There's nothing to prevent somebody else from doing this," says Peter O'Kelly, a senior analyst at market researcher Burton Group in Midvale, Utah.

Still, JotSpot has won some early fans. Opware Inc., a Sunnyvale (Calif.) maker

of software to manage corporate data centers, was using a Web form for customers to sign up for training. The forms piled in as e-mails, and administrators had to type all the details into a calendar. Now a Web sign-up automatically goes to an Opware training wiki, saving work and reducing errors. And the wiki automatically pulls in data on each customer from the Web, providing instant access to information that helps Opware tailor training. "Information just flows a lot more quickly," says Opware Chairman Marc L. Andreessen, co-founder of Web browser pioneer Netscape Communications Corp.

JotSpot is betting on the Web all the way. Instead of selling the software, it's offering it as a hosted service on the Web, charging \$5 per user per month during its current test phase. It's also hoping to hop on the open-source trend, encouraging outside programmers to sell applications in a Web gallery JotSpot will run. Whether or not JotSpot itself succeeds, even rivals are encouraged by its high-profile debut. "It's a validation of the wiki way," says Socialtext CEO Ross Mayfield—one that may help usher in a new world of do-it-yourself software. ■

—By Robert D. Hof in Palo Alto, Calif.

Wiki World

Up to now software programs called wikis had been used mainly by nerds to create collaborative Web sites. Now they're blossoming into a far easier way to write customized online applications, from managing customers to tracking projects.

THE PROBLEM

Conventional applications are costly, inflexible, and hard to learn.

THE SOLUTION

JotSpot aims to turbocharge wiki software so nonprogrammers can write applications that draw on the Web's wealth of data and services.

THE CHALLENGES

Competition looms, both from wiki startups such as Socialtext and from groupware sold by IBM, Microsoft, and Groove Networks.

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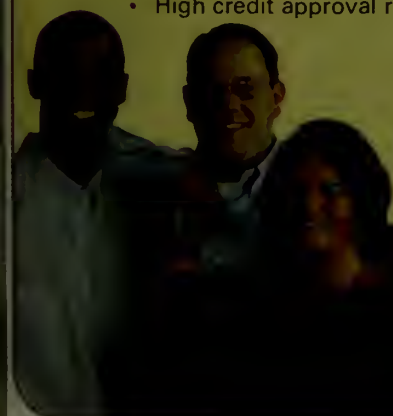
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Getting a Grip On the Grid

More companies are farming out jobs to groups of networked computers

DEEP IN THE BOWELS OF the USTA National Tennis Center in Flushing, N.Y., a dozen producers were busy updating the US Open Web site one September evening. They crowded around a TV and gasped as tennis star/fashionista Serena Williams strode onto the court wearing a studded outfit and knee-high black boots. Within moments, photos of her were up on the Web site. But while her outfit caused a stir, the technology powering the site was just as remarkable.

To handle surges of demand from sports fans, USOpen.org was plugged into

a powerful computing grid run by IBM. Big Blue had linked dozens of servers at its data centers so they behaved like one big computer. Any computer on the grid could serve up a US Open Web page one minute and do bank credit analysis the next. Customers get computing power when they need it. "It's truly an on-demand business," says Ezra Kucharz, the USTA's managing director for advanced media. "We get the resources we need. If we don't need them, others use them."

After a lot of hype and a long buildup, grid computing is going mainstream. Grids allow processing jobs to be split up and farmed out over a network to many computers so the work can be done fast

on any machine that's available—and organizations can trim their hardware and labor costs. For years most grids were used for scientific research. But that's changing. Analysts say 300 to 500 grids have been set up by—or for—businesses in the past year or so. And more are on the way. Of 149 large North American companies surveyed recently by Forrester Research Inc., 37% have set up grids, and 30% are actively considering it.

PAYING WITH PLASTIC

IT'S TOO EARLY FOR ANY one or two tech companies to dominate the market, but they're scrambling for advantage. IBM, which has been selling supercomputer grid services for more than a year, announced on Oct. 1 a wide offering of utility-like computing services, including grids, from 11 IBM data centers around the world. Sun Microsystems on Sept. 2 unveiled its own grid-on-demand service with the wrinkle that customers can buy dollops of computing power for an introductory price of \$1 per processor per hour, and even pay with a credit card.

Now the popularity of grids could get another boost. *BusinessWeek* has learned that in October a new industry group, the Globus Consortium, will be announced. It's rallying around a grid technology standard called Globus. Tech heavyweights including Hewlett-Packard, Intel, Sun, and IBM are expected to be among the founding members. They plan to in-

How Grid Computing Works

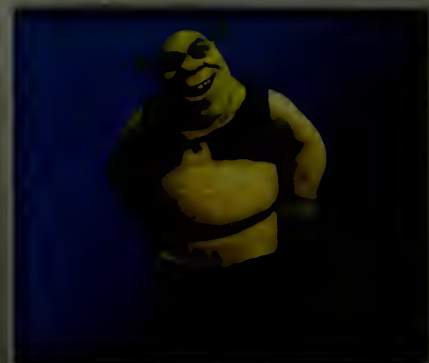
Here's how DreamWorks Animation uses technologies to create films such as *Shrek 2* and *Shark Tale*.



1 Artists create digital 3-D characters and scenes on graphics workstations. These can handle design, but not the heavy data-crunching needed to render the figures.



2 Grid software deals out the animations in bite-size pieces to a cluster of server computers in DreamWorks data centers. These add color, texture, and lighting.



3 If more computing is needed, work is farmed out to more computers at a Hewlett-Packard data center. When all the pieces are complete, they are reassembled for editing.

Information Technology

ide the Globus Toolkit, open-source software used for building grids, as a common ingredient in their grid products. The goal: to link seamlessly hardware and software made by different companies. This move pleases tech purveyors. "We want to put things together in a grid and not worry about lack of interaction," says Mark Cates, chief technology officer for investment banking at Archovia Bank, which has a grid for pricing derivatives.

In fact, conflicting standards remain the biggest obstacle for grids. Many major tech companies have released grid products based on their own proprietary technologies. While most of them plan to adopt standards as they emerge, there's one major holdout: Microsoft Corp. So far it's sitting on the sidelines. Its so-called Dynamic Systems

initiative, which is supposed to show up in products next year, presumes that people who want to tap into shared computers will use just one kind—machines running Windows. "Our approach is, first and foremost, we'll make it work on Windows," says Charles Fitzgerald, general manager of platform strategy at Microsoft. "There's way too much standardization that takes place prematurely before they have done the engineering work." Most grid software allows grids to include Windows servers, but the process of setting up and operating

What's Driving Grid Computing?

After years of hype but not a lot of action, hundreds of companies are starting to use grids of computers to handle large information processing jobs. Here's why.

COST-CUTTING PRESSURES: Using grids allows tech purchasers to get more use out of computer servers they already have purchased and spend less on new computers because they do not have to be as powerful.

NEW GRID TECHNOLOGIES: In the past year, tech companies have delivered products that make it relatively easy to set up grids—though it's more complex if they don't use the same operating software.

STANDARDS ARE COMING: In October, the new Globus consortium will adopt a standard technology designed to make it easier to set up grids comprised of different kinds of computers.

those grids would be easier if Microsoft played along.

Corporations aren't waiting for the industry to achieve mind meld before building grids, though. DreamWorks SKG has a system that can hand off the rendering of animations to an HP data center at night after its artists go home. And Acxiom Corp., which analyzes customer interactions for banks, retailers, and credit-card issuers, uses a grid to sift through millions of records per hour.

For those willing to risk trying out a new technology, the rewards can be rich. At most companies, each application typically runs on its own dedicated server. As a result, analysts estimate, organizations use about 15% of their computing power, and they spend far more on servers than needed. By distributing work through

grids, companies can save a lot of money. C. Alex Dietz, Acxiom's chief information officer, says he cut his annual data analysis expenses in half by switching from a single \$2 million mainframe-style computer to a grid of cheap servers running the Linux operating system. And he can process in four to five days jobs that used to take a month.

Most grids focus on huge number-crunching jobs like Acxiom's, but that's changing. Grids are starting to handle everyday tasks that demand instant answers. Broker Charles Schwab & Co., for instance, has an application that lets investment advisers sit down with clients and size up different strategies, then ask the grid to analyze those strategies and produce scenarios. The answers, which require billions of calculations, come back in seconds.

The dream is to tap into grids as we now plug appliances into outlets. That goal is years off. The technologies are immature, security must be improved, and all the standards aren't yet in place. This will be one of those advances that takes many years to make its full impact felt. But for many corporate computer users, it will be worth the wait. ■

—By Steve Hamm
in New York

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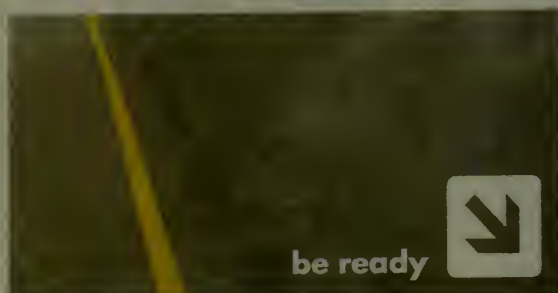
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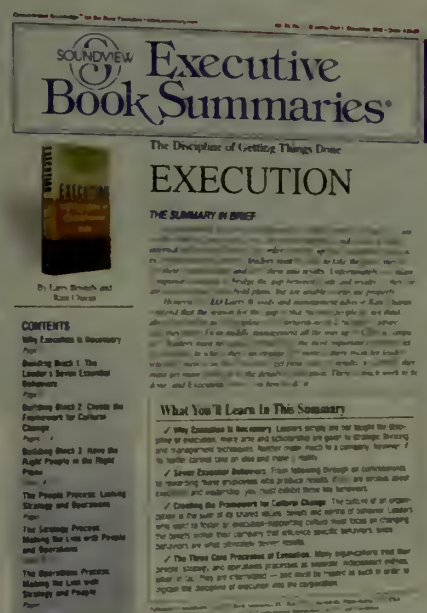
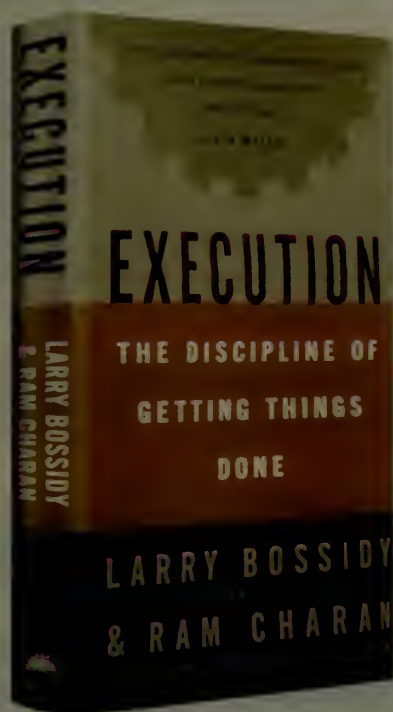
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Suddenly Steel Has Industrial Strength

Prices are up, as world demand forges ahead. And this time, the boom could last

TWO YEARS AFTER AN unprecedented contraction, Big Steel is back. And it's hotter than a freshly poured ingot. Demand is up in the U.S. and worldwide, lifting steelmakers from a deep and painful downturn. Prices for some types of steel have tripled in the last 12 months and—for the first time in years—the industry is attracting Wall Street's attention for all the right reasons. What's even more surprising, for such a cyclical industry, is that this reversal of fortune may last. At Nucor Corp., which recently boosted its quarterly profit forecast by 38%, CEO Daniel R. DiMicco believes the "bullish cycle" could stretch out for years, sweeping up iron ore producers, scrap dealers, and steel distributors. In the meantime, the boom is pinching users, from auto-parts suppliers to giants such as Caterpillar Inc. But with few major new plants under way, fresh capacity won't trigger a new bust anytime soon.

American steelmakers owe much to China for this turn of fate. Prior to 2000, a worldwide steel surplus kept prices down in the U.S. Since then, the global economy has perked up and China's appetite for steel has skyrocketed. Demand is forecast to

surge by 17% this year, to 280 million metric tons. And since Beijing has made steel-intensive infrastructure development such a high priority, the market shouldn't shrink even if growth cools off, says Mary O'Connor, an analyst at Locker Associates Inc. in New York. "Demand will be strong at least through the 2008 Beijing Olympics."

The industry's robust future isn't guaranteed, of course. If Beijing slams on the economic brakes, steel demand could plummet. But that seems unlikely. And even if prices soften later this year, it won't augur a return to the bad old days, say analysts and executives. Demand is rising everywhere and global production is nearing its maximum. "From the Asian Tigers to Brazil, every part of the world is steel-short today," says David Sutherland, CEO of Ipsco Inc., which makes the steel plates used in pipelines and ships.

So far, galloping demand hasn't induced any U.S. players to commit to the sort of new capacity that could send prices south. Even with mills running almost

flat out, capital spending projections aren't rising by much. Mostly, U.S. players are content to tweak their current facilities to boost capacity. Many are still cutting jobs as they seek to become competitive with nonunion minimills and foreign producers. Ipsco, for example, is spending about \$60 million to hike output at existing mills, but Sutherland sees no reason to build in the U.S.

No wonder stocks of Nucor and U.S. Steel Corp., among others, are near all-time highs. The runup has also enriched financier Wilbur Ross Jr., who created International Steel Group Inc. by buying up bankrupt steel assets. ISG shares are up 25% since their debut last December.

COOKING RAW ORE

EVEN IN CHINA, foreign steelmakers are shy about investment. U.S. Steel and Luxembourg's Arcelor, the world's biggest steelmaker, are pursuing lower-risk operations, such as finishing plants. None is building new so-called integrated mills there, says Karlis M. Kirsis of World Steel Dynamics in Englewood Cliffs, N.J. These behemoths, which can cost up to \$2 billion to construct, make new steel by cooking raw iron ore in huge furnaces. China's larger, state-owned steelmakers are focusing on upgrading existing facilities, by using better raw materials and updating technology. Some are also adding minimills, which convert scrap into new steel. Only about a quarter of China's recent additions to capacity are integrated mills, all built by private Chinese companies.

As for steel consumers, the steep prices are beginning to bite. While large end-users such as Caterpillar can raise their product prices to keep pace, the pain is hitting the smaller companies, especially in the auto sector. Carmakers' long-term contracts have insulated them from the price spike so far. But they'll face higher prices on new contracts, and their smaller suppliers are exposed. In early October, Internet Corp. in Troy, Mich., filed for Chapter 11 protection, citing high steel

and material prices. "It's just the start," says analyst Jim Gillette at CSM Worldwide Inc. in Farmington Hills, Mich. "Many suppliers don't have the margins to hold on." For steelmakers, at long last, these worries are in the past. ■

—By Adam Aston in New York and Michael Arndt in Chicago

PRECIOUS METAL



WHAT'S IN A NAME? Well, if you've got a lot of them on your voice and data equipment, moving to IP without breaking the bank can seem pretty daunting. Avaya makes it easy for you to jump right in, efficiently, reliably, and securely. As the world leader in enterprise IP telephony,

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IP Telephony

Contact Centers

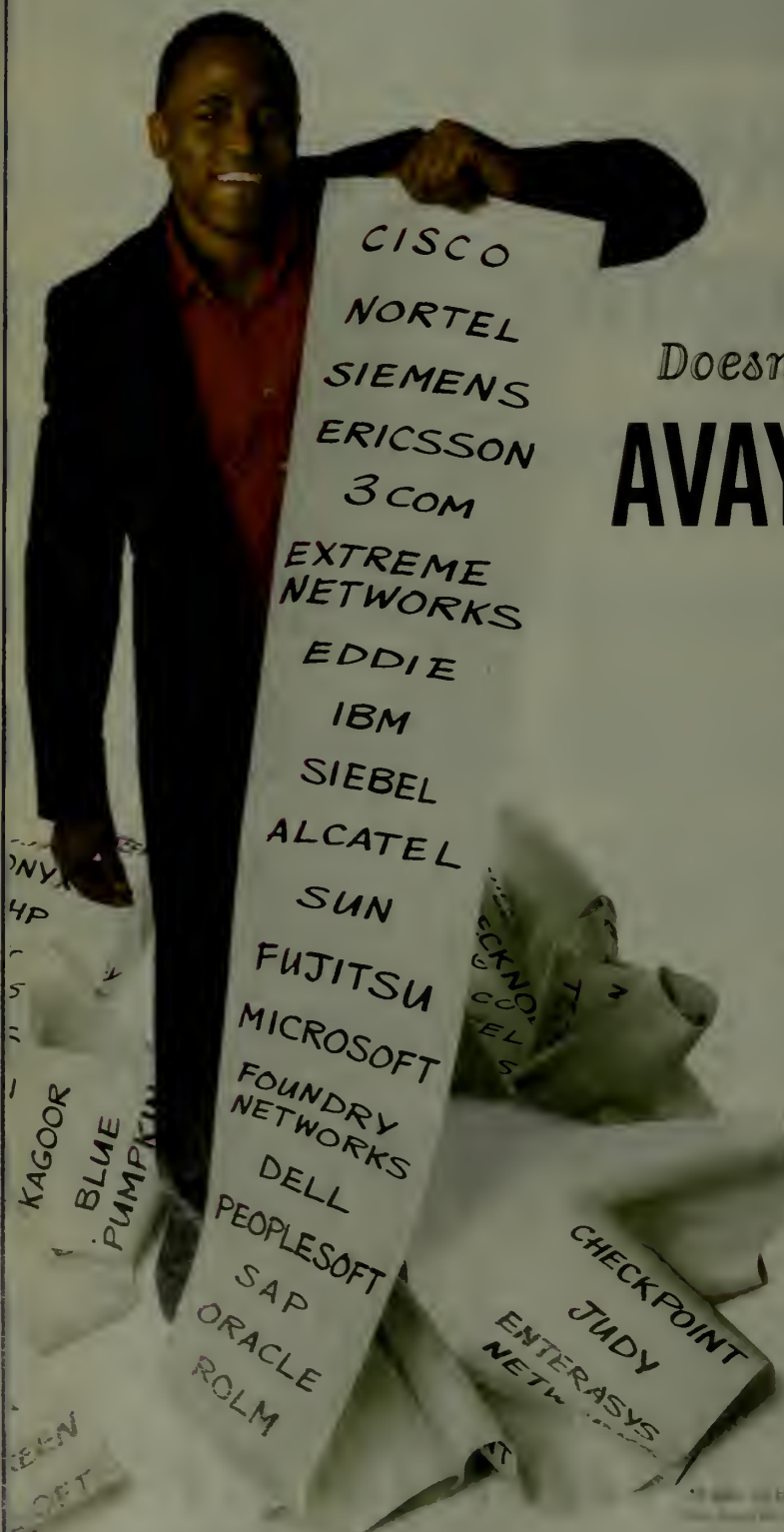
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CRM

On the Corporate Front Line

When Sales and Service Are the First and Last Lines of Defense

Ready, Aim, Compete!

In any industry, the competitive battle for the customer is fierce. Often pre- and post-sales services are more important than the price or quality of the product being sold. The best-outfitted companies have the knowledge and tools to understand, respond and be proactive to customer needs. CRM is their weapon of choice.

ARMED with CRM

CRM systems provide data aggregation and process management allowing organizations to be more responsive and accountable for continuous improvement, profitable new customer acquisition, cross-selling, and customer retention. New technologies providing real-time analysis and data capture can give front-line employees instant access to critical information during valuable interaction time with customers and prospects. The goal is to best direct and support front-line workers to successfully sell and service customers in today's landmine-laden world where consumers are hyper-conscious of privacy rights and suspiciously impatient with any type of sales offer.

CRM is a broad term that covers virtually any technology that touches or impacts the way companies interact with customers. Some systems focus on back office activities such as marketing

and product management, while other systems emphasize the front-line operation with inbound and outbound call center support and sales force automation. However, depending on the industry and size of the business, there may not be a formal call center or even chartered sales people. Call them business development, agents, private or personal bankers; every business has some function responsible for the acquisition of new clients and/or add-on business to existing customers. More and more businesses are requiring that every front-line employee have some sales responsibility.

Ideally, front-line systems not only provide relevant and secure information about the targeted customer or prospect, but the systems also enable the employee to collect and archive valuable information obtained from multi-channel interactions they have with customers, whether the interaction is in person, via e-mail, phone, Web chat, the company Web site or other customer accessible online system. This 'interactive' information then becomes part of the overall customer profile. For example, consider a customer that mentions that they are pregnant to a front-line employee. Whether the business is a bank or car dealership, this information can be a trigger to market new products to this customer. Such interactive information

is not typically available in corporate databases. Therefore, having the ability to capture that piece of critical intelligence on the front lines can make a significant difference in front and back office customer-related decisions. Rick Lowrey, EVP for Deltek, a provider of application software and solutions to over 8000 project businesses and professional services firms worldwide, noted, "The CRM system is more than a way to automate sales. It becomes the repository of every aspect of the customer relationship across all of the business processes."

To take full advantage of the system, the front-line CRM applications need to be integrated with the marketing, accounting and other back office systems. This allows the organization to push out information to the front lines. For example, a customer service representative can see whether a customer's maintenance is paid up, the status of a pending order, or that the customer has been mailed a specific marketing campaign.



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Oregon-based Motorcycle-USA.com, the premier Internet site for motorcycle enthusiasts, uses Avaya IP Office, an all-in-one voice and data solution for small and mid-size businesses. The system provides them with integrated contact center software for call queuing, recording and comprehensive reporting functions that allow the company's customer service manager to monitor call volume and response times as well as track dropped calls.

More sophisticated systems help generate "next best product" recommendations or customer retention risk warnings so that the front-line employee can proactively participate in the sales and support of that customer. Additionally, technologies such as real-time collaboration can assist a front-line worker when they need other expertise to effectively answer customer questions. Self-help systems abound to help both customers on their own as well as the company employees who need training or quick reference information. Marco Emrich, president & CEO of CRM provider SEDONA Corporation noted, "A well integrated CRM solution includes the ability to push and pull critical customer information from and to anywhere in the organization. The CRM system becomes the information network and management tool that helps coordinate the entire organization to execute the corporate goals."

You Cannot Manage, That Which You Cannot Measure

Regardless of the type of system used, a key requirement for front office CRM systems is the ability to manage and measure sales and support activity without adding overhead to the front-line operations. Through CRM automation that leverages workflow and business process management (BPM), companies are able to ensure valuable leads and follow-up service activities do not fall through the organizational cracks. They are also able to analyze their operations from an objective bird's eye viewpoint to allow them to continuously improve efficiencies. Hand-in-hand with measuring sales and support effectiveness,

companies need complimentary compensation incentives. This helps drive the behavior of front-line employees to align with the overall goals of the organization.

Attack New Markets, Defend Your Base

Some companies quote that the cost to replace a good customer is as high as 20:1 – that is, for every good customer lost, you must acquire 20 new ones to replace the profit lost. And while using technology to find highly qualified leads is getting easier with better analytics and easier access to data, knowing who to retain or who to acquire is usually the easy part. Enabling the entire organization to participate in these goals is the hard part. Equipped with the latest in CRM technologies and knowledge gained from the veterans with early market experience, corporations continue to wage war on both domestic and international competitive threats by using CRM to find better ways to acquire, foster and retain loyal profitable customers.

About The Author

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EDITED BY OTIS PORT

INNOVATIONS

Of oil paintings and smarter locks

During one summer's internship, Evan Quasney may have overturned decades of art-preservation technology. The 19-year-old University of Michigan mechanical engineering student worked at the Smithsonian Institution, weakening computer models to determine the best method for conserving priceless paintings. Frequently, braces have been fitted onto the backs of paintings to prevent the old canvas from sagging. But Quasney showed how this practice creates stresses that

cause cracks. The best anti-cracking technique? Apply a layer of gesso to the backside. A clever lock system set to be launched late this year will let businesses equip their

entire premises with high-security card-key readers for a fraction of today's costs. Developed by Assa Abloy, a Stockholm lockmaker, and CoreStreet, a Cambridge (Mass.) software company, the KeyFast system ends the need to have every door connected to a central network. Instead, when employees start work each day, the first lock checks their smart card, PIN, and fingerprint. Then that lock loads the card with daily access codes for all the internal doors to which they have been granted access. Each lock will cost around \$1,000 but save a bundle thanks to its simple installation.

—By Rachel Tiplady

BLOWUPS A 1956 Goodyear rubber craft—and the unmanned wings



AIRCRAFT

AN INFLATABLE PLANE IN YOUR BACKPACK

BLIMPS AND BALLOONS aren't the only inflatable means of taking to the air. Fifty years ago, Goodyear actually built Inflatoplanes like the one above. They didn't catch on, in part because pilots had little protection in a crash.

For unmanned aerial vehicles (UAVs), though, inflatable wings are just the ticket, figures ILC Dover, a leading supplier of blimps and airships. Soldiers, border guards, and aerial photographers could lug fairly large UAVs, such as the five-foot-wingspan prototype

pictured here, in a backpack. For tracking drug smugglers in speedboats faster than Coast Guard cutters, the Frederica (Del.) company even has an artillery shell that sprouts inflatable wings after being fired from a naval gun. It's powered by a small jet, but other models can use a propeller engine.

Inflatable wings will first see duty in the skies over Israel, thanks to a deal Israel Aircraft Industries just inked with ILC Dover. NASA may use inflatable planes someday to explore Mars.

FUEL CELLS

BUILDING A BETTER MEMBRANE

IT'S JUST A THIN sheet of plastic, but what a difference it may make in automotive fuel cells. PolyFuel claims it has developed a plastic membrane that enables fuel cells to deliver a better driving experience while trimming costs.

The heart of a fuel cell is its membrane. Coated with a catalytic agent, the membrane coaxes electrons to leave hydrogen atoms, then pulls the nuclei—"naked" protons—through the membrane. The electrons, which get left

behind, flow out as electricity.

Since NASA developed the first fuel cells four decades ago, DuPont's Teflon has been the best material for membranes. But a Teflon membrane in a car cell costs \$5,000. Also, it loses efficiency in hot weather and when the car climbs long, steep hills.

PolyFuel's membrane is half as costly and shrugs off summer heat. And, says James Balcom, CEO of the Mountain View (Calif.) startup, it is engineered with nanoscale blocks to deliver 10% to 15% more juice. Spun off in 1999 by SRI International, PolyFuel so far has raised \$40 million to introduce the results of 14 years of fuel-cell research at SRI.

BLOOD WATCH

THIS NEW DEVICE FILTERS OUT THE FAT

THE WHITE-HAT version of cholesterol, called HDL, earns its reputation by carrying the bad kind—LDL—to the liver for excretion. But many people have too much LDL to expunge naturally. That can lead to plaque deposits that clog arteries. Statin drugs are one therapy, but more drastic measures are sometimes necessary.

Lipid Sciences in Pleasanton, Calif., is working on a sort of dialysis treatment for cholesterol: a proprietary filtration device that extracts and cleans the blood. When the precious liquid is returned to the body, the HDL particles are ready to scoop up maximum loads of LDL.

Dr. Lawrence Rudel at Wake Forest University School of Medicine plans to test the new approach in monkeys with heavy plaque deposits. If the treatment proves safe and succeeds in shrinking the deposits by even 5% during a 24-week monkey study, a human clinical trial could start as soon as next year.

—Amy Tsao



(LEFT) PHOTOGRAPHS BY THE BRIDGEMAN ART LIBRARY/GETTY IMAGES; (TOP) BETTMANN/CORBIS; (RIGHT) A. PASIEKA/PHOTO RESEARCHERS INC.

On Your Side?

Some handy ways to figure out whether your fund manager is likely to put the shareholders' interests first. **BY ANNE TERGESEN**



UNTIL RECENTLY, MOST investors asked just one thing of their mutual funds: red-hot returns. Now, in the wake of the trading scandals that harmed the shareho-

lders of some funds, investors are also looking for fund management they can trust.

Of course, when it comes to sizing up a fund, trustworthiness isn't nearly as easy a measure as performance or fees. But by examining the behavior of a fund's managers and directors, you can get a sense for how strongly the fund is acting in the shareholders' interest. The Securities & Exchange Commission is pushing good fund governance practices, too. Among them: new requirements that funds hire compliance officers by Oct. 5 and stop channeling trading commissions to brokers as a reward for promoting the sales of their shares by Dec. 31. In addition, starting next year, companies will have to disclose how they determine a fund manager's pay.

Like corporations, each mutual fund has a board responsible for safeguarding shareholder interests, so it's important to know whether directors have conflicts of interest. For instance, about 22% of directors disclose in fund documents that they are "interested"—generally meaning they have business or economic ties to an investment adviser, broker, or other firm that provides services to a fund. The data come from a forthcoming mutual fund board compensation study by Equilar, a San Mateo (Calif.) compensation-search firm that examined the most recent annual filings, through early August, of 100 of the largest fund families. The SEC recently approved a rule that requires fund boards to appoint a chairman who is independent and to fill 75%

ore of the seats with independent direc-
s by early 2006, up from the current re-
irement of more than 50%.

How can you tell whether a fund is like-
to put its shareholders first? Unfortunately,
there's no litmus test. Nor is there a
arantee that a fund with strong policies
on't mess up. Indeed, despite a reputa-
n for pro-shareholder policies, the advi-
ry firm and manager running the
idgeway Funds recently agreed to pay
most \$5.2 million to settle SEC charges
overbilling investors in three funds by
.4 million when it used the wrong for-
ula to calculate performance-based fees.
areholders will receive \$4.9 million in
stitution and interest, with the remain-
r covering penalties.

Nonetheless, you can take steps to pro-
tect yourself. Start by examining the ex-
tent to which those running your fund—
e directors and managers—are
otivated to act in your interests. To as-
ess that, ask your fund for the Statement
Additional Information (SAI) that it's
quired to file annually with the SEC, or
ownload a copy at sec.gov. (Hint: look
filings with the number "485").

Y PACKETS

ERE YOU CAN FIND OUT how much
e directors are paid. The higher their
aries, the harder they may find it to
ck proposals—such as fee reductions—
at help shareholders but hurt the man-
ement companies, says Kunal Kapoor,
ector of fund analysis at Morningstar.
ual compensation for independent
ectors—which comes from the funds,
t the management firms—runs from
250 to more than \$800,000, with the
edian paycheck at \$83,000, according
Equilar. Among the highest-paid inde-
ndent directors: Dreyfus funds
airman Joseph DiMartino—a past
resident of the fund company—who col-
cted \$800,306 in 2003; Putnam Chair-
an John Hill, who earned \$413,625 in
03; and three Franklin Templeton di-
ctors—Harris Ashton, Joseph Fortuna-
and Gordon Macklin—who made
69,700 each in the fiscal year ended
pt. 30, 2003. The fund families with the
ighest median pay for independent di-
ctors are Fidelity, Dreyfus, and Putnam,
ch at about \$250,000 per director, ac-
rding to Equilar.

Dreyfus says DiMartino's pay reflects
e fact that he oversees "approximately
0 portfolios." Hill says the Putnam di-
ctors were paid more than usual over

Giving Your Fund a Grade

To gauge a fund's shareholder friendliness,
Morningstar assigns "fiduciary grades" from
A to F. Morningstar gives high marks to
funds with clean regulatory records and pay
packages that reward managers for long-
term performance, among other factors.
The raters give low marks to funds with
above-average fees among other traits. Here
are some top- and bottom-ranked fund
companies:

TOP-RANKED FUND COMPANIES	NO. OF FUNDS RATED A	SHARE OF FUNDS RATED
Bridgeway	3	75%
Davis	5	100
Dodge & Cox	4	100
ICAP	4	100
Masters' Select	4	100
Metropolitan West	4	100
Payden	3	100
Third Avenue	3	75
Wasatch	3	43
Weitz	3	100

BOTTOM-RANKED FUND COMPANIES	NO. OF FUNDS RATED D OR F	SHARE OF FUNDS RATED
AIM	23	100%
AllianceBernstein	7	100
Columbia	13	100
Dreyfus	11	73
Evergreen	3	100
Fremont	2	100
Gabelli	4	44
INVESCO	5	100
PBHG	3	100
Scudder	4	27
Smith Barney	3	27
Strong	8	100
Van Kampen	8	89

Data: Morningstar

the past year because of a board investi-
gation of market-timing abuses that ne-
cessitated holding about three times the
routine number of meetings. The compa-
ny, he adds, is reimbursing the funds for
the additional pay. Franklin says that it
requires its directors to invest one-third of
their pay in Franklin funds to align their
interests with those of shareholders.

Fund-management companies, on the
other hand, aren't required to disclose
how much they pay portfolio managers.
But starting next year, the SEC is requir-
ing funds to divulge in the SAI the formu-
las they use to determine manager com-
pensation, says Julie Allecta, senior
partner at law firm Paul Hastings Janof-
sky & Walker. With that information,
you'll be able to judge whether the man-
agers get a better payoff from hitting
long-term goals or maximizing short-
term performance. If you're a long-term
investor yourself, you'll want to have a
portfolio manager who, like yourself, is
interested in long-term results.

BEHIND ASSET GROWTH

CONSIDER THE STATE STREET Research
Aurora fund, which specializes in small-
cap stocks. Like many other fund com-
plexes, State Street rewards its managers
based partly on asset growth, according to
Morningstar. For shareholders, though, as-
set growth can be a mixed blessing. To be
sure, when assets rise because of invest-
ment gains, it's a good thing. But when
they grow as new investors pile into a
fund, it can become difficult for managers
to buy and sell stakes in small companies
without negatively affecting stock prices.

In part for this reason, Aurora earns
low marks for shareholder friendliness
from Morningstar, which recently
launched "fiduciary grades" (table) on its
premium Web site. (The site charges
\$12.95 a month or \$115 a year.) Alyson
Lindsey, a spokesperson for State Street,
says the firm has periodically closed the
Aurora fund to new investors to keep as-
set growth in check. It now restricts new
investment to current shareholders and
clients of designated brokers.

You'll also want to know whether
managers and directors are investing
along with you. By examining funds' reg-
ulatory filings, Equilar found that 13.4%
of all fund directors have yet to invest a
dime of their own money in the funds
they oversee. They include longtime di-
rectors John Shane at CDCNvest, Elliot
Jaffee at Smith Barney, Lonnie Pope at
Enterprise, and—as of Dec. 31—Richard
Leach at Wells Fargo.

How much investment is enough?
Morningstar likes to see directors put
away a sum greater than their annual
pay. A spokesperson for CDC IXIS, the
parent company of CDCNvest, says since
the last fund filing, Shane purchased
shares valued between \$10,001 and

Personal Business

\$50,000. That's below his 2003 annual pay of \$81,950. A spokesperson for Citigroup, parent of Smith Barney, says: "The majority of our independent directors do own shares in the funds they oversee." Wells Fargo declined to comment. An Enterprise spokesperson says the company does not believe directors' ownership "has any bearing on their ability to serve in the best interests of the funds' shareholders."

If you want to find out how much your

portfolio manager has invested, you can do so starting next year. As is the case with directors, the data will be published in the SAI in broad ranges—from "none" to "over \$1 million" (vs. from "none" to "over \$100,000" for directors). Because Morningstar likes to see managers put a substantial portion of their net worth on the line, it asks funds to volunteer this information. Most, but not all, provide the data, Kapoor says.

Another way to assess shareholder

friendliness is to look at a fund's past behavior. Morningstar applauds fund companies with below-average fees and clean regulatory records. It frowns on those that fail to close funds before they become bloated.

Having the right policies won't necessarily inoculate a fund. But not having them is a red flag. So rather than make a leap of faith, sit down and review the disclosures. You may very well end up choosing a better fund. ■

Autos



A Caddy Aimed at The Continent

Its new STS could give BMW and Mercedes a run for their money, even in Europe. **BY DAVID WELCH**

HAVING ALREADY staged an impressive turnaround in the U.S., General Motors' top-shelf Cadillac Division is poised to go after not only American drivers who love upscale European cars but Europeans as well. Its latest entry, the STS sedan, which ranges from \$41,000 to \$63,000 (with all-wheel drive), has the daunting task of duking it out in the luxury sports sedan market with popular cars like the BMW 5 Series, Mercedes E-Class,

and Audi A6. To launch its bold play, Cadillac showed off the new STS at the Paris Motor Show in late September and let journalists from around the globe drive it around the French countryside.

I took the STS on some winding roads outside Nice to see what it could do. The car can really tear it up. That's not a total surprise, since it's built on the same platform as the smaller CTS, which can perform as well as some BMWs. I gave the pedal a punch, and the car's 320-horsepower V-8 kicked up a cloud of dust and got me to 60 mph in a hurry. Cadillac says

HEAVY HITTER

The STS is weighty, but it can still tear up the road

the 0-to-60 trip takes six seconds in a rear-drive car (like the one I was testing), seven seconds if the car has the V-6 or combo of

8 and all-wheel drive. That's plenty fast, but I have to wonder how it would do in a sprint against its rivals. The A6 has more horses, and *Motor Trend* says the BMW 545i is faster.

With all-wheel drive and a V-8, the STS weighs in at more than 4,200 pounds—about 10% heavier than a 540i. When I took the car on a tight turn doing about 50 mph, I could feel its weight leaning into the turn and had to fight to bring the car back out and keep it straight when I came out of the bend. Still, handling is nearly as tight and precise as the Continental competition. The car can dive in and out of turns nicely. Its traction control system keeps the vehicle firmly planted.

BAUHAUS SIMPLICITY

INSIDE, THE STS is proof that GM is spending plenty more these days on nicer leather seats, cool dashboards, and slick gauges. The seats are covered in soft Tuscan leather that makes for a cushy throne. The dashboard, center console, and steering wheel are lined with eucalyptus wood. The whole instrument panel looks well crafted and has a Bauhaus simplicity that eschews the overly scientific look of the first all-new Caddies that debuted in early 2003.

Overall, the STS still doesn't beat European rivals. But well equipped at \$45,000 with a V-6 and \$52,000 with a V-8, it'll set you back about \$7,000 less than a comparable 545, making it a credible option. That alone could make a fervent lover of European sports sedans give Caddy a look. ■



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Eye Surgery: It's Getting Sharper

LASIK has improved, and newer techniques can fix trickier vision problems. **BY LEWIS BRAHAM**

DR. ROBERT MALONEY envisions a world without glasses. Maloney, a Los Angeles ophthalmologist, was an early practitioner back in 1991 of laser eye surgery, or LASIK, to correct nearsightedness. He has also tested other vision-correction technology for the Food & Drug Administration (FDA). Based on that, he has concluded that in 20 years eyeglasses will be obsolete. "I think my grandchildren

won't even know what they are," he says.

LASIK alone won't get us there. But other techniques are evolving to fix all kinds of vision problems, including near- and farsightedness and presbyopia—the focusing condition that makes reading glasses ubiquitous among middle-aged people. Among the treatments are phakic intraocular lenses, which are implanted directly in the eye, improvements in LASIK, and new radio-wave technology.

Lens implantation has been around for several decades. But because it typically re-

quired removal of the eye's natural lens, it was performed mostly on cataract patients nearing blindness. In the new phakic approach, the contact lens is attached to your natural lens and held in place with tiny stitches. Based on Maloney's experience, the results are better than with lasers. "Unlike LASIK, the procedure is reversible" there are negative side effects, he says. One type of phakic lens, called Verisyse, was approved by the FDA in September. Another, ICL, should win final approval in the next few months.

Traditional intraocular lenses, which require the natural lens to be removed, also have improved dramatically with the advent of Crystalens, approved by the FDA last November. These lenses adjust their focus with a patient's eye muscles to give them seamless near or distance vision. "In the past, implanted lenses for cataract patients provided clear vision only at a single fixed focus, usually distance," says Neil Martin, a cataract surgeon in Chevy Chase, Md. "Patients still needed reading glasses." Because Crystalens surgery involves removing the patient's existing lenses, Martin recommends it for cataract patients. Such focus adjustability may not be available in phakic lenses for at least four years.

FEWER SIDE EFFECTS

COMPARED WITH LASIK, phakic lens implantation seems to cause fewer cases of hazy or spotty vision, dry eyes, and other side effects. On the other hand, "entering the eye introduces greater surgical risks for a large number of patients who do beautifully with LASIK," says Douglas Koch, an ophthalmology professor at Baylor College of Medicine in Houston. In addition to infections, there is a risk of developing glaucoma or cataracts, triggered by abrasion of the natural lens.

Still, for Clark Miller, a Manhattan Beach (Calif.) lawyer, the phakic lens surgery was worth the risk. At 39, he has worn glasses or contacts his entire adult life, but they cramped his style. "I climb mountains, backpack, sail," he says. "Cleaning the dust from a hiking trail or your contact lenses is almost impossible."

Miller's vision was so poor that LASIK was not an option. That's why last October he became one of the FDA trial cases for the Verisyse lenses. Miller had each eye operated on separately. He wore an eye patch for a few days and didn't see perfectly at first, but his vision improved gradually. A month after the surgery, he had 20/40 vision. Today, it's 20/15.

LASIK itself has improved in the past two years, thanks to two new technol-



New Sightlines

The options available to fix your vision are multiplying. A few of the new procedures:

CONDUCTIVE KERATOPLASTY

(left) offers hope for those with reading glasses. The method uses focused radio waves to change the eye's curvature.

PHAKIC LENSES are inserted surgically in front of a patient's natural lens and can be removed if necessary. Phakics promise fewer visual flaws.

WAVEFRONT

analysis improves traditional laser treatments by customizing the fixes made to each patient's unique eye features.

es: a diagnostic technique known as wavefront and a proprietary laser procedure developed by IntraLase. Approved in 2002, wavefront tools measure the acuity and quality of a patient's vision 25 times more accurately than traditional vision tests. They record how the eye processes light and map out distortions unique to each individual. Ophthalmologists study the map before shaping the patient's cornea to correct for distortions.

PRESSIVE RESULTS

THE RESULTS FROM wavefront procedures have been impressive. In one FDA study, 94% of wavefront LASIK patients had at least 20/20 vision after the procedure; 74% had better than that. "Twenty-four hours after my surgery, my vision was 20/15," says Matthew Opremcak, a

Calabas (Calif.) pharmaceutical sales rep who had wavefront LASIK last month. "I get in my car, and I can see the differentiation in the leaves on trees, and my night vision has vastly improved." Treatment of both eyes with LASIK, customized with wavefront, runs about \$5,000. Some insurers cover LASIK, but many don't.

In addition, instead of using metal blades to cut a flap in the cornea to perform LASIK procedures, doctors can now wield a secondary laser from IntraLase, leading to a more precise cut, says Baylor's Koch. Some surgeons debate the need for the device, however. "The standard microkeratome blade gives you a more precise cut than the laser if used properly," says Maloney. "Intralase offers an advantage for inexperienced surgeons because it's harder to make a mistake."

Although LASIK is less invasive than implanting contacts, it still involves the removal of corneal tissue. Conductive keratoplasty (CK) uses radio waves to shrink the collagen, a fibrous protein, in the eye—and there's no cutting. This procedure increases the curvature of the cornea, improving near vision. Approved by the FDA in March, conductive keratoplasty is mainly for those who need reading glasses but whose vision is fine otherwise.

The procedure runs about \$1,500 per eye and is only a temporary fix: "The improved vision lasts about three to five years," says Ernest Kornmehl, an ophthalmology professor at Harvard University. Still, given how rapidly vision technology is evolving, it probably won't be long before someone figures out a way to throw out those glasses for good. ■



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AND FOR ACT II?

Easing the Tax Bite On Your IRA

Converting it now to a Roth IRA lets you take advantage of today's low rates. **BY LEWIS BRAHAM**

FEW PEOPLE LOOK FOR REASONS to pay taxes early. But if you have a traditional individual retirement account and you're a retiree, young career person, or wage earner who meets certain income requirements, you might want to withdraw the money now, cough up the income tax, then place the funds in a Roth IRA. It's a bet that today's low federal tax rates will be higher in the next few years.

The tax cuts enacted by Congress at President Bush's behest have made the rates on most income brackets as low as they've ever been. At the same time, those cuts have caused revenue shortfalls, which combined with spending on the Iraq war and

new Medicare drug benefits, have created a record deficit of \$477 billion. "The deficit reveals that we have been living beyond our means, and it has to be paid back somehow," says New York financial planner Lewis Altfest. "Economic growth alone will not cover it." All of that means tax rates are sure to rise, at which point it will cost you more to convert to a Roth.

To recap, with a traditional IRA, you don't pay taxes on the money you invest or on its earnings. Taxes are due on withdrawals, which can start as early as 59½ or as late as 70½. With a Roth IRA, you contribute aftertax dollars, but future withdrawals come out tax-free. "I like to use the farmer analogy," says Ed Slott, editor of *Ed Slott's IRA Advisor* newsletter. "With the Roth, you pay a tax on the seed, but the crop grows for free. With a tradi-

tional IRA, it's the other way around.

The conventional wisdom says Roth conversions make sense only for young investors who have time for their accounts to recoup the taxes they have to pay on the traditional account. But if you are an older investor and have a young heir, perhaps a grandchild, who stands to inherit the IRA, you might consider converting as well. Here's why: If a 10-year-old were to inherit your Roth IRA, the child would be allowed to accumulate tax-free gains for life. In that light, the conversion costs are inconsequential. The only proviso is that the heir must start taking tax-free distributions from the account immediately. But since the government calculates the required distribution based on life expectancy, the amount for a child would be quite small—1.4% of assets for a 10-year-old.

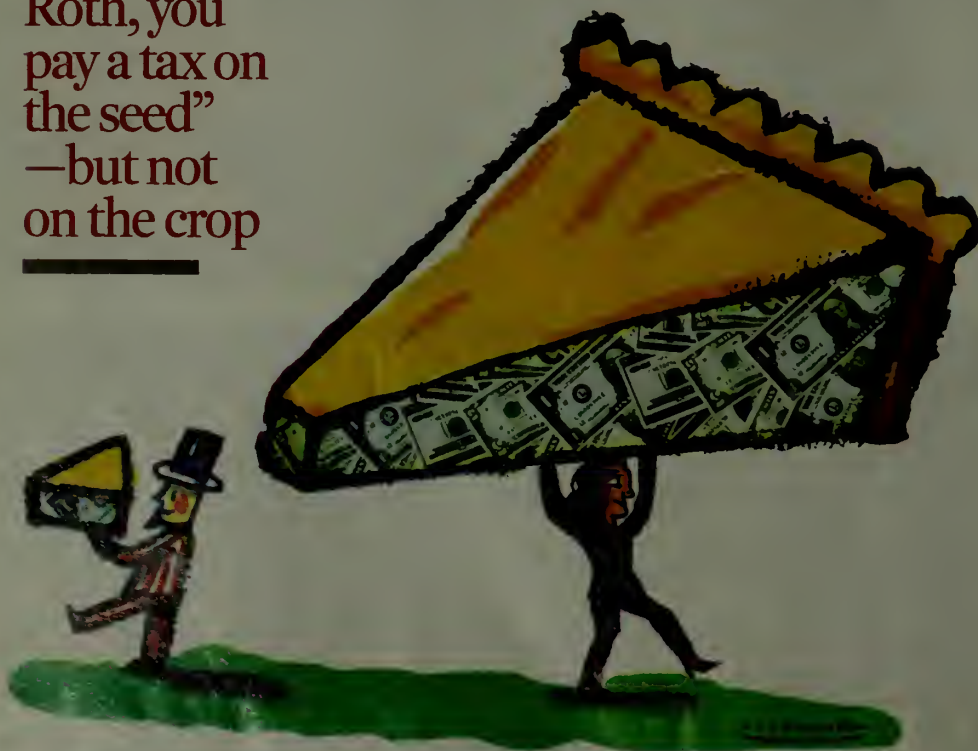
SAME TIME NEXT YEAR?

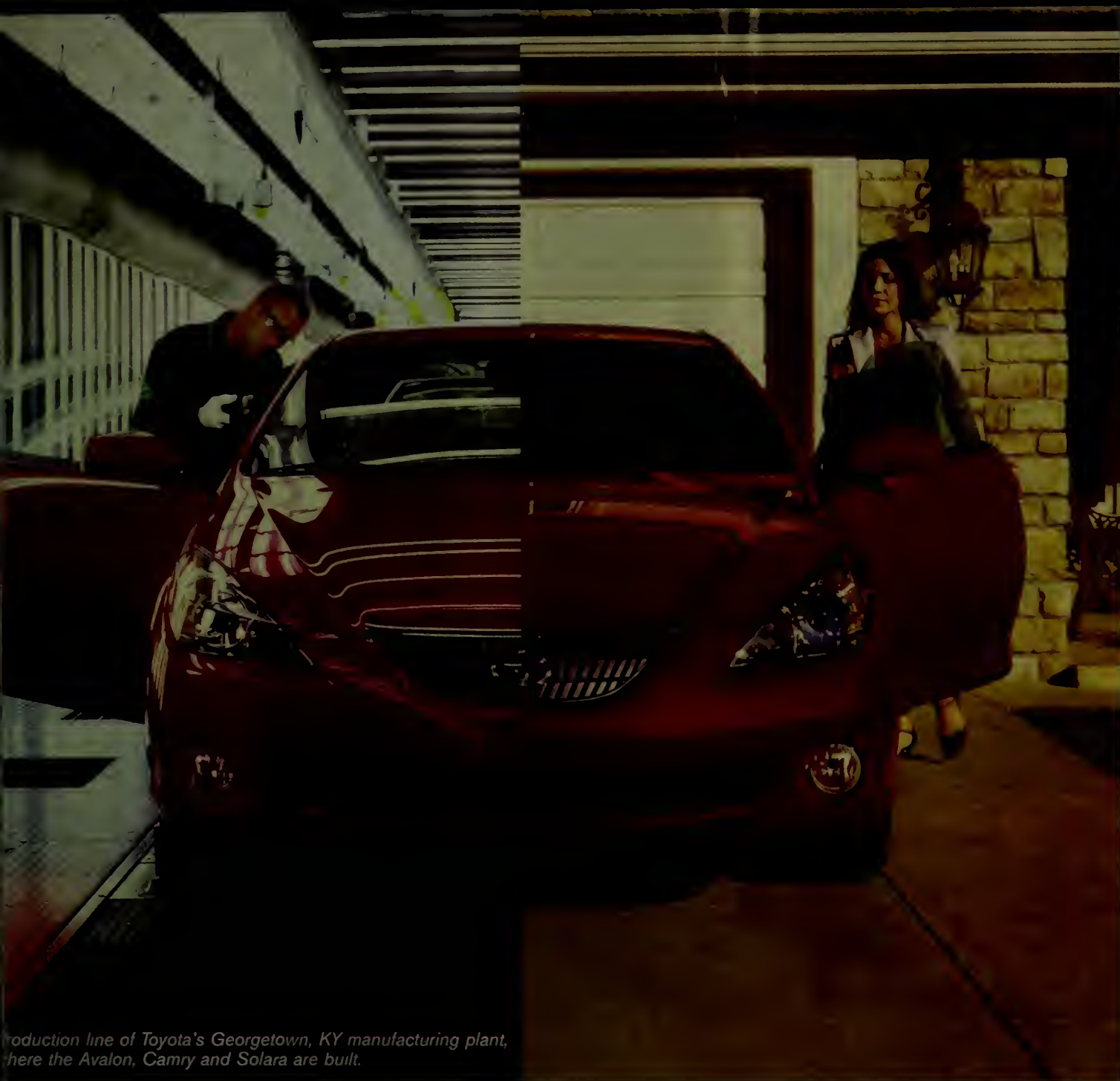
THE ONE MAJOR OBSTACLE to a Roth conversion is that the account holder, whether single or married filing jointly, may earn no more than \$100,000 in modified adjusted gross income—a form of AGI created just for the purpose of calculating eligibility for a Roth conversion—in the year of the switch. That may mean you won't qualify for 2004, but keep it in mind when you're doing tax planning for 2005 and beyond. You may be able to lower your income enough in a future year to take advantage of the move: making maximum contributions to 401(k) plans, delaying yearend bonuses, realizing capital losses, or bunching up deductions.

The Internal Revenue Service does not consider IRA conversion money as part of modified adjusted gross income. So even if you have \$1 million in your IRA, converting it to a Roth wouldn't put you past the \$100,000 limit. What if you're a retiree receiving minimum distributions that put you past that limit? Currently that would prevent you from making the conversion. But the rules are changing next year so distributions no longer count toward modified adjusted gross income. So just wait until 2005 to convert.

Still, some people will not benefit from moving to the Roth. Among them are retirees with no younger heirs or people who can't afford to pay the up-front taxes out of non-IRA funds. If you use your IRA money to foot the tax bill, it will reduce the amount you can roll into the Roth. Finally, if you're near age 70½ and need the IRA distributions to live on, you shouldn't worry about leaving it to your heirs. Otherwise, as far as conversions go, there's no time like the present. ■

"With the Roth, you pay a tax on the seed"—but not on the crop





Production line of Toyota's Georgetown, KY manufacturing plant, where the Avalon, Camry and Solara are built.

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For many Americans, Toyota is more than just a source of transportation, it's a source of income. With our eight manufacturing plants, sales and marketing operations, research and design facilities, and through our dealers and suppliers, Toyota's U.S. operations are responsible for more than 190,000 jobs. Each year, Toyota team members built more than one million vehicles in the U.S.* And with two new manufacturing plants on the way, we're working to create even more jobs and opportunities in the communities where we do business.

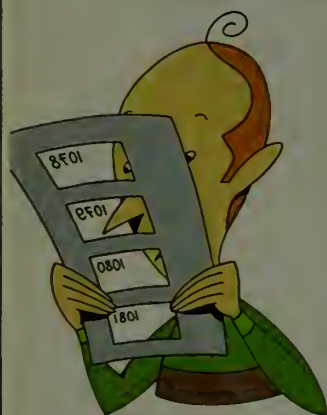
*Components and vehicles are made using many U.S. sourced parts. ©2004

EDITED BY TODDI GUTNER

BANKING

NOW IT WON'T BE SO EASY TO GET THE FLOAT

HOW OFTEN HAVE YOU WRITTEN a check greater than your bank balance, figuring you'll deposit money before your check clears? Try that after Oct. 28, when the grand-sounding **Check Clearing for the 21st Century Act**, known as **Check 21**, goes into effect, and you may be in for a rude shock. Instead of having to ship paper checks across the country, banks will be able to transmit electronic images of



checks to each other, so the time it takes an out-of-state check to clear may shrink from about three days to one, and some checks may clear the day they're written.

That means check writers accustomed to a three-day or so cushion may be hit with penalties for bounced checks. (The average is \$25.80.) Another change is that you may no longer get back all your canceled checks. Instead you'll receive digital images on paper, called "substitute checks," that for legal purposes are the same as the originals. Gail Hillebrand of **Consumers Union** advises you to monitor statements in case of snafus where the paper check and its electronic image both get paid, or in case errors creep in when a check goes to electronic form.

Banks and credit unions must notify you of the changes only if you get your checks back now, or request a copy of a check. Some have begun contacting customers already, but they're not required to do so until the first statement after Oct. 28. The act does not, alas, mandate that you get access to funds from checks you deposit any faster; that's up to your bank. One likely impact of **Check 21**: increased use of debit cards. That will be a boon for banks, because debit cards provide fee revenue. For more information, go to www.consumersunion.org/finance/ckclear1002.htm. —Suzanne Woolley



WINES

Fat Bastard, Please

FISH, DRAGONSTONE, AND TORTOISE CREEK don't sound like French or German wines. But they are. Old World producers, harking back to the success of European wines such as Blue Nun in the 1970s, are dropping foreign names for easy-to-pronounce English brands. So instead of Weingut Johannes Eser/Johannishof Rüdesheimer Berg Rottland Riesling Spätlese, you get Bend in the River. Fat Bastard, one of the first to adopt this strategy, has become a top-selling French import in the U.S.

Most of these wines fall in the \$10 to \$20 range and are quite drinkable. That's because improved winemaking technology has resulted in better quality at lower prices. Also, makers of branded wines can blend grapes, which means when one vineyard or region has a bad year, the wine doesn't have to suffer.

Old World vintners aren't the only ones adopting catchy names. California's **E. & J. Gallo Winery** just launched Red Bicyclette in the U.S. The line includes a merlot, syrah, and chardonnay, all from the south of France. The labels feature a beret-wearing Frenchman with baguettes in his bicycle basket. —Natalie MacLean

TIME OFF

WHERE FASHIONISTAS once shopped, you can now see political and **sacred artworks from Himalayan countries**. The new Rubin Museum of Art, which opened on Oct. 2, has taken over a spot once occupied by upscale retailer Barneys New York in Manhattan's Chelsea district. Sacred Passage to Himalaya, photos of soaring peaks by Kenro Izu, will get you in the right mindset for viewing selected works from the 1,500-piece collection of paintings, textiles, and sculpture (rmanyc.org). —Lauren Young



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1.4 trillion in U.S. institutional investment products were benchmarked to the S&P 500 in 2003; source Nelson's MarketPlace Web database. 2.1 trillion in U.S. equity retail funds were benchmarked to the S&P 500 in 2003; source Morningstar, Inc. \$1.1 trillion in U.S. assets were directly indexed to the S&P 500 in 2003; source Standard & Poor's Survey of Indexed Assets. Standard & Poor's does not sponsor, endorse, sell or promote any S&P index-based investment product.



BY ROBERT BARKER

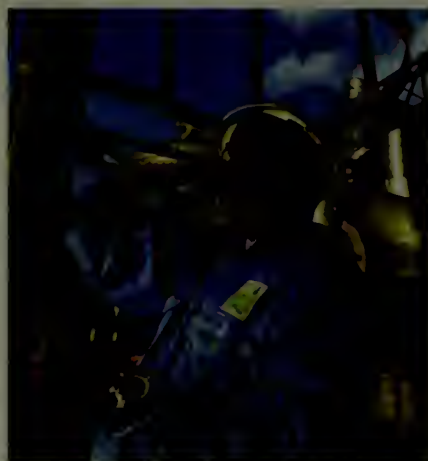
An Oil Giant for Players With Patience

How long will Wall Street keep Royal Dutch/Shell Group in the doghouse? After laying out new plans for growth in recent transatlantic meetings with institutional investors, the energy giant failed to win parole. Two days of talk only left its shares 6% lower. Given the gravity of its transgression—overstating its estimate of proven reserves by nearly 24%, for which last summer it agreed to pay U.S. and British regulators \$150 million in fines—Royal Dutch/Shell can count on doing much more than the five months facing Martha Stewart.

Consider that time your opportunity. Royal Dutch/Shell—an unusually complex company with two different stocks and headquartered in both the Netherlands and Britain—strikes me as one of those special situations made for individual investors. More than Wall Street pros, with their focus on quarterly results, individuals can afford to be patient as a sturdy company rehabilitates itself. Near \$52 (Royal Dutch) and \$45 a share (Shell Transport & Trading), the stocks have badly lagged peers and now trade at a discount to them. With the world thirsting for oil and natural gas, chances are good that this gap will narrow.

EVEN IN TODAY'S CRISIS of confidence, Royal Dutch/Shell remains in the top tier of supremely profitable oil titans, with BP and ExxonMobil. While it has already tightened its process for estimating reserves, further corporate governance reforms are due to be announced in November. In the first half the company saw revenue climb 17%, to \$157 billion, with operating profit jumping 25%, to \$15.8 billion. The gains came despite a 4% slide in output, to 3.8 million barrels of oil-equivalent a day. It expects daily output will sink as low as 3.5 million bbl. next year and in 2006, a worrisome trend.

Just the same, Charles Ober of the T. Rowe Price New Era Fund sees potential for “a decent spurt in earnings that would surprise the Street.” Ober, whose fund is up an annual average of 18% in the last three years and has big stakes in Royal Dutch along with its rivals, told me some 30% of the company’s capital is tied up in work that’s yielding little or no current return. Profits from some of these



IN NIGERIA Shell’s offshore project should start yielding profits in two years

projects—liquified natural gas at Russia’s Sakhalin Island, Canada’s Athabasca tar sands, or the Bonga deepwater field off Nigeria, for example—are a good bet to flow noticeably two years from now.

So far the Bonga

project has not been disrupted by Nigeria’s political strife.

Meantime, Royal Dutch/Shell is paying relatively rich dividends. How rich may be obscured because comparing foreign-source payouts is tricky. Netherlands-based Royal Dutch withholds for taxes up to 25% of its dividends. So a taxable U.S. investor would not have seen the \$2.11 that Royal Dutch paid in two distributions this year, but \$1.59. (U.S. investors can claim a deduction or credit for those taxes). Shell, however, is based in Britain. There, a new tax treaty with the U.S. ended such withholding. It doesn’t help that some popular databases report foreign dividends before taxes, some after taxes, still others after varying rates of taxes.

To get past the confusion, Standard & Poor’s energy analyst Tina Vital suggests looking at dividends before withholding. Drill down, and you will find such a comparison is favorable to Royal Dutch/Shell (table). Exxon Mobil is yielding 2.1% and BP 2.9%. Royal Dutch/Shell expects to raise its dividend at least in step with inflation. If so, then Shell in the coming year should yield 3.9% and Royal Dutch 4.2% or so. Next to the 2.6% on a two-year Treasury note, it’s not a bad way to do time in Wall Street’s pokey. ■

E-mail: rb@businessweek.co

Are Royal Dutch And Shell Bargains?

COMPANY/SYMBOL	PRICE*	2004 RET.*	DIVIDENDS**	'04 EPS***	P-E	'05EPS***	P-E
BP BP	\$57.55	19.4%	\$1.67	\$4.05	14.2	\$3.61	15.9
Exxon Mobil XOM	48.92	21.5	1.04	3.39	14.4	3.07	15.9
Royal Dutch Petroleum RD	51.72	3.0	2.11	4.30	12.0	3.64	14.2
Shell Trans. & Trading SC	44.55	3.1	1.71	3.91	11.4	3.28	13.6

*Oct. 4 **Trailing 12 months gross of foreign withholding taxes, ***Estimates

Data: Company reports, ComStock, Standard & Poor’s and IBES estimates

CANCER

At Bristol-Myers Squibb, our mission is clear. To discover and develop innovative treatments for the world's most serious diseases, such as cancer, AIDS and mental illness. To erase their devastating

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Hope, Triumph, and the Miracle of Medicine



BY GENE G. MARCIAL

EYETECH'S MACULAR-DEGENERATION DRUG MAY GET O.K.'D SOON

STORM DAMAGE HAS MOBILE MINI CONTAINERS IN HOT DEMAND.

DAWN LEPORE COULD BE THE RIGHT Rx TO CURE DRUGSTORE.COM

Is Pfizer Eyeing Eyetech?

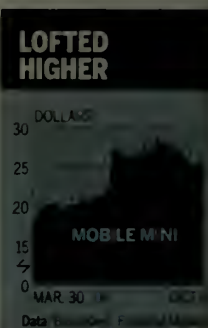
THE TUG-OF-WAR between bulls and bears over Eyetech Pharmaceuticals (EYET) may be settled soon: Bulls say the Food & Drug Administration will approve its chief product, Macugen, in December; bears say no. But the FDA is apt to run with the bulls, says Robin West, senior portfolio manager at the Santa Fe (N.M.) State Investment Council, which owns shares. The FDA's ophthalmology advisory panel recently "unanimously voted in favor of Macugen," notes West. Macugen is a new therapy for macular degeneration, which affects 1.7 million Americans. In 2002, Pfizer signed a \$750 million pact to help develop and market Macugen. Pfizer may buy Eyetech once Macugen is O.K.'d, West figures. In August, Eyetech stock fell from 46 to 32 as rumors spread that the panel would say no. But in September it rallied and is now at 36. "FDA approval is on track for late 2004," says Eric Ende of Merrill Lynch, which has done banking for Eyetech. Rating the stock a buy, he has a 12-month target of 53. Because Macugen "fills an unmet medical need," says Ende, it could generate sales of \$90 million in 2005 alone. Already in the market is Novartis' rival product, Visudyne, which Ende says has "limited efficacy." Eyetech should turn profitable in 2005, he says, earning 19¢ a share, and 81¢ in 2006. Pfizer declined comment. Eyetech didn't return a call for comment.



Mobile Mini Reaps A Whirlwind of Sales

HURRICANES HAVE CREATED a sudden market for Mobile Mini (MINI), a provider of storage containers to retailers, hospitals, and government agencies. Mobile buys used containers from shippers, fixes them up, and rents them for extra storage. Construction outfits also use them for offices. Mobile has five outlets in Florida, and this year's storms have enhanced Mobile's prospects, says David Gold of investment firm Sidoti, who rates the stock a buy—and has upped his 2004 and 2005 earnings forecasts. Since March, the stock climbed from 16 to 26. Gold sees it hitting 35 in a year. (Mobile appeared in this column on July 2, 2001, at 29—and leaped to 40 in early 2002.) Another Mobile fan is Ken Duc of Times Square Capital, which has a 5.4% stake. Mobile

"generates strong cash-flow and high profit margins," he says. Sidoti's Gold says demand will be up for 18 months or so, as repair and rebuilding progress. Florida accounts for 10% of sales, he says, and new business should add some 7% to earnings. Mobile has 100,000 containers located in 48 branches in 28 states. This year, Gold figures Mobile will earn \$1.34 a share in 2004 on sales of \$164 million, and \$1.60 in 2005 on \$181 million.



Can a Savvy CEO Rescue This Web Druggist?

DRUGSTORE.COM (DSCM) was a Net highflier: It hit 70 in 1999 but fell to 46¢ in 2001. Now at 3.80, the Web drugstore, which sells online health and beauty items plus prescriptions, has seen sales more than double—from \$110 million in 2000 to \$245 million in 2003—and they are estimated at \$300 million in 2004. Still, Drugstore.com is not earning a penny. Nevertheless, Joan Lappin, president of Gramercy Capital Management, has bought shares. Why? The company has hired a new chairman and CEO, Dawn Lepore, the former vice-chairman of Charles Schwab. A former Wal-Mart director and currently on eBay's board, she has the marketing and tech skills to turn things around, says Lappin. Drugstore's contact-lens business—acquired in 2003—has been a big drag, says Lappin. But Drugstore has ample cash—and little debt—and could keep it going for a spell without having to sell shares, Lappin says. So she thinks the stock is an "interesting speculation" that could hit 10 in 12 to 18 months. One big shareholder: Bill Gates's wife, Melinda, who owns 3 million shares and is a director. Morgan Stanley's Mary Meeker, a top Internet analyst, rates the stock "equal weight/attractive." ■



BusinessWeek online Gene Marcial's Inside Wall Street is posted at businessweek.com/today.htm at 5 p.m. EST on the magazine's publication day, usually Thursdays. See Gene on Fridays at 1:20 p.m. EST on CNNfn's *The Money Gang*.

Note: Unless otherwise noted, neither the sources cited in Inside Wall Street nor the firms hold positions in the stocks under discussion. Similarly, they have no investment banking or other financial relationships with them.

Personal Business Figures of the Week

STOCKS

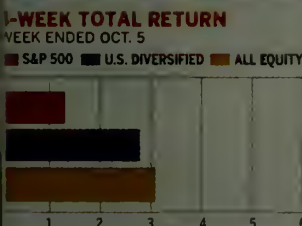


COMMENTARY

Stocks were jolted after Merck took Vioxx, its multibillion-dollar drug, off the market on Sept. 30, citing health concerns. But equities soon recovered and continued to rise for the rest of the week. This market's showing is as especially impressive given the relentless rise in oil prices and the rise in interest rates. Investors are betting on strong earnings from Corporate America.

Source: Bloomberg Financial Markets, Reuters

MUTUAL FUNDS



Source: Standard & Poor's

U.S. MARKETS

	OCT. 6	WEEK	% CHANGE YEAR TO DATE	LAST 12 MONTHS
S&P 500	1142.1	2.4	2.7	10.4
Dow Jones Industrials	10,239.9	1.0	-2.0	6.7
NASDAQ Composite	1971.0	4.1	-1.6	4.1
S&P MidCap 400	605.9	2.9	5.2	13.7
S&P SmallCap 600	301.0	3.4	11.3	20.6
DJ Wilshire 5000	11,165.0	2.6	3.4	11.2

SECTORS

	OCT. 6	WEEK	% CHANGE YEAR TO DATE	LAST 12 MONTHS
BusinessWeek 50*	664.5	2.5	6.8	11.9
BW Info Tech 100**	341.8	4.8	-2.5	2.4
S&P/BARRA Growth	551.2	2.0	-0.8	4.8
S&P/BARRA Value	586.7	2.9	6.3	16.2
S&P Energy	287.8	4.5	28.4	41.9
S&P Financials	390.2	1.6	2.7	9.8
S&P REIT	130.8	3.5	13.0	17.0
S&P Transportation	214.9	3.0	6.4	17.2
S&P Utilities	129.9	2.2	9.7	15.0
GSTI Internet	155.1	3.9	7.2	7.6
PSE Technology	704.6	4.1	1.0	8.8

*Mar. 19, 1999=1000 **Feb. 7, 2000=1000

GLOBAL MARKETS

	OCT. 6	WEEK	% CHANGE YEAR TO DATE	LAST 12 MONTHS
S&P Euro Plus (U.S. Dollar)	1211.0	2.4	2.7	19.9
London (FT-SE 100)	4706.3	2.6	5.1	10.2
Paris (CAC 40)	3764.6	2.2	5.8	14.7
Frankfurt (DAX)	4049.7	3.3	2.1	18.9
Tokyo (NIKKEI 225)	11,385.4	5.6	6.6	5.2
Hong Kong (Hang Seng)	13,271.6	1.9	5.5	13.2
Toronto (S&P/TSX Composite)	8871.9	2.8	7.9	17.3
Mexico City (IPC)	11,090.9	1.0	26.1	41.9

FUNDAMENTALS

	OCT. 5	WEEK AGO	YEAR AGO
S&P 500 Dividend Yield	1.69%	1.74%	1.60%
S&P 500 P/E Ratio (Trailing 12 mos.)	20.0	19.7	28.9
S&P 500 P/E Ratio (Next 12 mos.)*	16.2	16.3	17.6
First Call Earnings Surprise*	2.21%	3.99%	13.77%

*First Call Corp.

TECHNICAL INDICATORS

	OCT. 5	WEEK AGO	READING
S&P 500 200-day average	1119.0	1117.7	Positive
Stocks above 200-day average	64.0%	57.0%	Neutral
Options: Put/call ratio	0.76	0.90	Positive
Insiders: Vickers NYSE Sell/buy ratio	3.86	3.89	Negative

BEST-PERFORMING GROUPS

Application Software	18.7	Steel	103.3
Internet Software	18.7	Oil & Gas Refining	78.5
Oil & Gas Refining	15.5	Internet Software	75.6
Comptr. Stge. & Perphs.	15.2	Internet Retail	67.6
Photographic Products	15.0	Photographic Products	60.4

WORST-PERFORMING GROUPS

Health-Care Distribtrs.	-9.8	Airlines	-30.2
Distillers & Vintners	-8.2	Health-Care Distribtrs.	-21.2
Food Wholesalers	-8.1	IT Consulting	-20.7
Tires & Rubber	-7.2	Semiconductors	-18.3
Soft Drinks	-6.5	Semiconductor Equip.	-15.3

EQUITY FUND CATEGORIES

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		LEADERS	
Precious Metals	14.0	Natural Resources	42.0
Latin America	11.3	Latin America	39.1
Natural Resources	9.1	Europe	23.9
Technology	9.0	Real Estate	23.3
LAGGARDS		LAGGARDS	
Japan	-2.1	Technology	-2.8
Financial	0.1	Large-cap Growth	4.9
Real Estate	0.3	Japan	5.5
Health	1.0	Small-cap Growth	5.9

EQUITY FUNDS

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		LEADERS	
U.S. Global Invsr. Gold	20.8	ProFunds Energy Ustr. Inv.	63.2
U.S. Gl. Invs. Prec. Mnl.	20.5	State St. Rsch. Rsrcs. A	62.3
ProFds. Smicdr. Ultsr. Inv.	18.9	iShares MSCI Austria Idx.	60.6
Jacob Internet	17.1	ICON Energy	58.1
LAGGARDS		LAGGARDS	
Rydex Dyn. Vent. 100 H	-11.1	GMO Asia III	-35.9
ProFunds UKSh. OTC Inv.	-11.0	Ameritor Investment	-33.3
ProFds. USH. Sm. Cap Inv.	-8.9	ProFds. Smicdr. Ultsr. Inv.	-33.1
ProFds. Phmcls. Ustr. Inv.	-8.1	Thurlow Growth	-31.8

INTEREST RATES

KEY RATES	OCT. 6	WEEK AGO	YEAR AGO
Money Market Funds	1.24%	1.19%	0.62%
90-Day Treasury Bills	1.70	1.71	0.90
2-Year Treasury Notes	2.68	2.59	1.62
10-Year Treasury Notes	4.22	4.09	4.24
30-Year Treasury Bonds	4.97	4.86	5.16
30-Year Fixed Mortgage †	5.78	5.71	5.99

†BancQuote, Inc.

BLOOMBERG MUNI YIELD EQUIVALENTS

Taxable equivalent yields on AAA-rated, tax-exempt municipal bonds, assuming a 30% federal tax rate.

	10-YR. BOND	30-YR. BOND
General Obligations	3.57%	4.63%
Taxable Equivalent	5.10	6.61
Insured Revenue Bonds	3.79	4.87
Taxable Equivalent	5.41	6.96

THE WEEK AHEAD

INTERNATIONAL TRADE

Thursday, Oct. 14, 8:30 a.m. EDT » The August foreign trade deficit is forecast to have widened \$51.3 billion. That's based on the median forecast of economists surveyed by Action Economics. In July, the trade gap narrowed to \$0.1 billion.

RETAIL SALES Friday, Oct. 15, 30 a.m. EDT » September retail sales most likely grew 0.3%, reversing a 0.3% drop in August.

Excluding autos, sales probably improved by 0.3% as well, following a 0.2% rise.

PRODUCER PRICE INDEX Friday, Oct. 15, 8:30 a.m. EDT » September producer prices probably climbed 0.2%, after an unexpected fall of 0.1% in August. Minus food and energy, core prices most likely inched up 0.1%, after slipping 0.1% in the prior month.

INDUSTRIAL PRODUCTION

Friday, Oct. 15, 9:15 a.m.

EDT » Industrial output is expected to have expanded by 0.3% in September, after a 0.1% gain in August. The average operating rate most likely ticked up to 77.4%, from 77.3%.

BUSINESS INVENTORIES Friday, Oct. 15, 10 a.m. EDT » August inventories probably rose 0.5%, following a 0.9% gain in July. Revived demand, as well as rising commodity prices, are causing businesses to increase inventories.

The BusinessWeek production index slipped to 228.5 for the week ended Sept. 25, but registered a 13.3% gain from the previous year. Before calculation of the four-week moving average, the index fell to 227.5.

BusinessWeek online

For the BW50, more investment data, and the components of the production index visit www.businessweek.com/magazine/extra.htm

CHOICES MULTIPLY FOR BUSINESS AIRCRAFT USERS



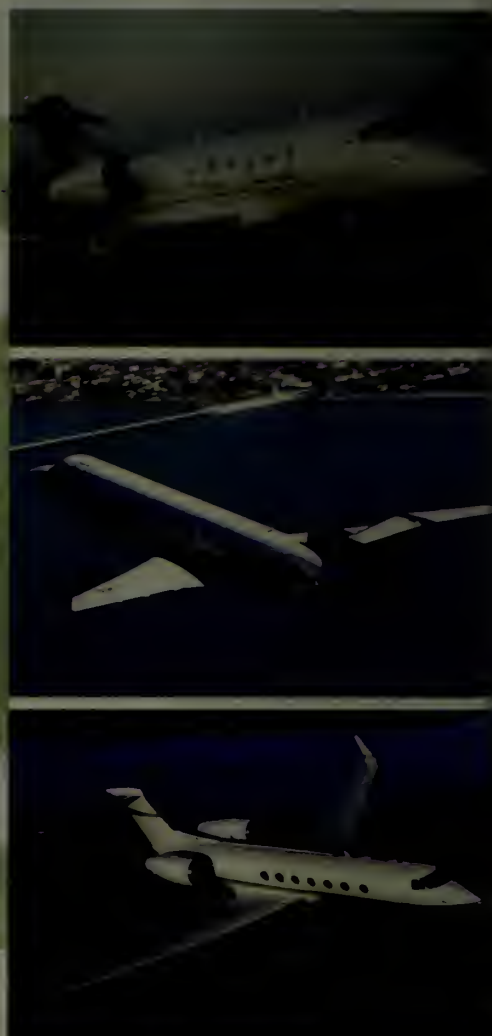
A host of new aircraft and an expanding array of utilization options are making business aviation an attractive option for a growing number of travelers.

For those interested in flying by business aircraft, there is no shortage of travel options. More efficient and capable airplanes continue to proliferate, and most major manufacturers have filled out their product lines to appeal to all types of users. In addition, a brand-new class of aircraft—the very light jet—promises to make jet travel more affordable beginning in 2006.

Furthermore, companies that heretofore have not been able to justify purchasing an aircraft now have many ways to enjoy the benefits of corporate flying without buying a complete airplane. Aircraft charter and fractional ownership continue to grow, and a new innova-

tion—jet cards—allows travelers to purchase a block of flight time for a single, fixed fee.

Following the recession of the early 1990s, corporate flying had grown steadily until 2001, when a combination of factors, including the Sept. 11 attacks and a weakening economy, “created a difficult environment for business aviation for a couple of years,” explained Ed Bolen, president of the National Business Aviation Association and former CEO of the General Aviation Manufacturers Association, which represents the major makers of business aircraft. “But so far, through the first half of this year, we have seen the deliveries of tur-

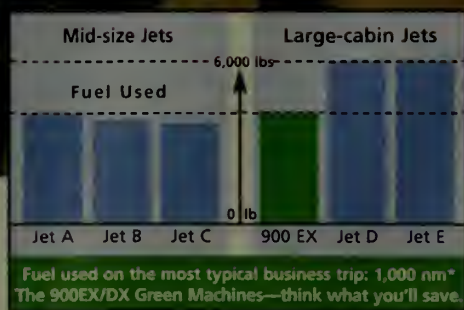


The Citation Mustang (left) is one of the new very light jets in development. New business aircraft that have entered service recently include the Bombardier 300 (top right) the Embraer Legacy (middle) and the Gulfstream G550 (bottom).

bine-powered (jet and turboprop) airplanes increase, and the manufacturers are reporting strong orders. So there is a sense that the recovery is well underway and that it probably will be sustainable for the foreseeable future.”

Some within business aviation have worried that the expanding number of equipment and utilization options “would ultimately cannibalize the traditional market of charter [operator] and traditional flight departments,” noted Bolen. “But as fractional ownership grew, we continued to have growth in the number of flight departments and charter operations. So what I think we are beginning to see is more acceptance

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*Source: Business & Commercial Aviation, May 2004

of the business aircraft in all of its different operating methods. I think people are beginning to understand the benefits of business aviation, and now they are looking at the method that is right for them."

The health of business aviation always has been tied to the economy, but the current surge in aircraft sales has been aided by tax benefits that became available in 2003. "Bonus depreciation" may expire by year-end if not renewed soon by Congress, but Bolen believes that if an extension is enacted in October, there will be a flurry of orders during the fourth quarter.

TECHNOLOGICAL ADVANCES

Besides tax incentives, there are numerous reasons why companies are buying new aircraft. New business jets incorporate significant safety and productivity advances, such as more precise navigation equipment, as well as collision-warning and enhanced-vision systems. Plus, business aircraft passengers now have the same communications capabilities in the air as they do on the ground, including Internet connectivity,

which solidifies the business jet's reputation as "an office in the sky." Many operators of older business jets are upgrading their aircraft or trading them in to capitalize on these technological advances.

Perhaps the best example of new technology are the very light jets, twin-jet aircraft that seat up to six people and cost less to buy and operate than even the most efficient of today's airplanes.

"There is a lot of anticipation related to the very light jets," said Bolen. "The idea that you are bringing down the price point of a business jet by the order of magnitude that the very light jet manufacturers are talking about will undoubtedly bring new customers into the market. Also, anytime you see new aircraft [enter the market], there are entrepreneurs who find new ways to utilize those airplanes."

ACCESS WILL BE KEY

As long as the economy remains healthy, industry observers see only one major threat to corporate flying. "All of the great challenges to business aviation are going to be related in one way or

another to the access issue—making sure that businesses that own and operate aircraft can fly where they want to, when they want to," declared Bolen.

"We have made a lot of progress [on access] since Sept. 11," asserted Bolen. "We are basically back at every airport in the country except [Washington, D.C.'s] Reagan National Airport. The airspace is largely available to us but for the TFRs [temporary flight restrictions]."

Indeed, TFRs have become problematic for many business aircraft operators. The government establishes, on short notice, no-fly zones over a variety of venues, including sports stadiums, entertainment complexes and wherever the President or Vice President travel. Although airliners can fly in such restricted areas, business aircraft cannot forcing operators to change their route or departure and arrival times.

"The frustration is that we still have not found a solution that will allow individuals and companies that voluntarily comply with security best practices an opportunity to turn that into access to TFRs or Reagan National," said Bolen. However, he sees "a glimmer of hope in a proposal that the Transportation Security Administration's Registered Traveler program be adapted for corporate aircraft use."

Despite the access issue and other challenges, the future looks bright for business aviation, said Bolen. "When you peel back all of the concerns that may be raised, you find that business aviation is a tremendous benefit to the country. It can be done securely, in an environmentally friendly way and in a way that promotes mobility without causing congestion or delays for the commercial airlines." ♦

FALCON 7X: THE FIRST VIRTUALLY DEVELOPED BUSINESS JET

The Falcon 7X is the first business jet to be developed entirely in a virtual environment, from design to manufacturing to maintenance. Using product lifecycle management (PLM) software, French aircraft maker Dassault Aviation and its partners worked on a common, collaborative, 3-D virtual platform to design and produce the new three-engine, intercontinental jet.

Dassault attributes the reduction in assembly time and improvement in parts quality to the precision made possible by the virtual process. The digital mockup of the Falcon 7X is so accurate that components developed virtually fit perfectly when they are actually assembled. Consequently, the need for traditional assembly tools has dropped dramatically, and Dassault does not even need to produce a 7X prototype.



The wing of the first Falcon 7X was attached to the fuselage recently. First flight is slated for 2005.

"The virtual platform has fundamentally changed the way we view building airplanes," said Jacques Pellas, Dassault Aviation's CIO. "Adopting PLM means improving the circulation of information in a company, redefining its processes and reorganizing company structures. We are just at the beginning of a new industrial revolution." ♦

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Shine a Hard Light On Fannie Mae

SHOULD WE BREAK up mortgage giant Fannie Mae? Is it so big and out of control that it threatens the entire U.S. financial system? A lot of people in Washington think so, especially after the 211-page broadside against it by the Office of Federal Housing Enterprise Oversight (OFHEO) on Sept. 22. Unfortunately, the financial questions about Fannie Mae are entwined with ideological battles between Republicans and Democrats. The truth is hard to come by. Yet one thing is increasingly clear: At the least, Fannie Mae and its smaller sibling, Freddie Mac, need a more sophisticated and powerful regulator.

Fannie Mae has fended off the kind of oversight common to other financial institutions. And OFHEO, which belongs to the Housing & Urban Development Dept., has been a weak regulator. It did bring to light possible accounting problems at Fannie Mae (which were denied by CEO Franklin Raines in Congressional testimony on Oct. 6). But the alleged manipulation of earnings may have started as early as 1998. Where was OFHEO? And just last summer serious accounting errors at Freddie Mac were disclosed. Where was OFHEO? It's time for serious, sustained oversight. Our choice is the Treasury Dept., which already regulates national banks.

It's also time for definitive information on just what Fannie Mae and Freddie Mac contribute to our economy. Fannie Mae, lest we forget, was a pioneer in the '80s and '90s in

securitizing debt, spreading risk, and expanding financial markets. This developed national secondary-mortgage markets for home loans and revolutionized the car, credit-card, and commercial mortgage-loan markets.

But research by the Federal Reserve suggests that today Fannie and Freddie may be far less useful to homeowners than many had assumed. Their enormous financial activities may lower mortgage rates by only seven basis points. Much of the savings from its implicit government backing appears to be going to shareholders in the form of higher profits and dividends. Fannie's managers also gain through their compensation. Fannie says it's own research shows big benefits for homeowners. We need to know if this is true.

**It's time
for real
oversight—
perhaps
from
Treasury**

We also must understand how much risk Fannie Mae pose to the financial system. Federal Reserve Chairman Alan Greenspan, a critic of Fannie Mae, told Congress in February that he is worried. Fannie Mae is the second-largest issuer of debt in the U.S., behind only the federal government. The immense size and scale of Fannie and Freddie may be making the financial system more vulnerable to unforeseen shocks. Greenspan wants to prevent that by slowing Fannie and Freddie's expansion. To do it, he would raise their capital standard. It's a prudent idea.

Fannie Mae has played a critical role in expanding homeownership in America, especially among first-time, minority, and low-income buyers. But there are serious questions that must be addressed about its governance, its benefit to society, and its risk to the financial system. This is not simply politics. It is an economic issue.

B-Schools: What It Takes To Be Best

THIS WAS THE YEAR academic quality largely determined standing in *BusinessWeek's* Best B-School rankings (page 62). Tough back-to-basics curricula supplanted breezy courses. Rigorous analytics pushed aside entertaining anecdotes. Both students and corporate recruiters—the “consumers” of B-school education who vote in our biennial survey—demanded more value from faculties. When they got it, they pushed those schools higher on the list. The lesson is clear to B-schools around the globe: Business is becoming ever more complex, and students want to prepare to work in the real world.

Take the University of Chicago Graduate School of Business, which landed at the No. 2 spot for the third time since the rankings began in 1988. Chicago's graduates were the favorite of companies that hire MBAs. Why? Chicago teaches critical thinking via theory, research, and hard analysis. One issue on campus this year is the ratio of adjuncts (often celebrity CEOs) to full-time faculty. Students love to hear the real-life stories of people who run companies. But the dwindling number of solid, research-oriented professors is a problem. Striking a balance will be a challenge.

One big surprise this year is the rise of B-schools in Europe and Canada. Many recruiters said that these MBAs were as good or better than their U.S. counterparts. Queen's University in Kingston, Ontario, jumped into first place in the 2004 ranking of MBA programs outside the U.S. It elbowed aside France's INSEAD by focusing on converting science and high-tech professionals into general managers. Barcelona's ESADE leapt to No. 4, thanks to its training in analytical and communications skills. And ESADE's local rival, IESE, moved up to No. 7.

The competition among B-schools is now global—and it's getting increasingly heated.



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THE UNSUNG CEO

United Technologies'
George David runs a
\$31 billion company
that outguns GE in
shareholder return.
Who is he—and
how does he do it?

DIANE BRADY (P.74)

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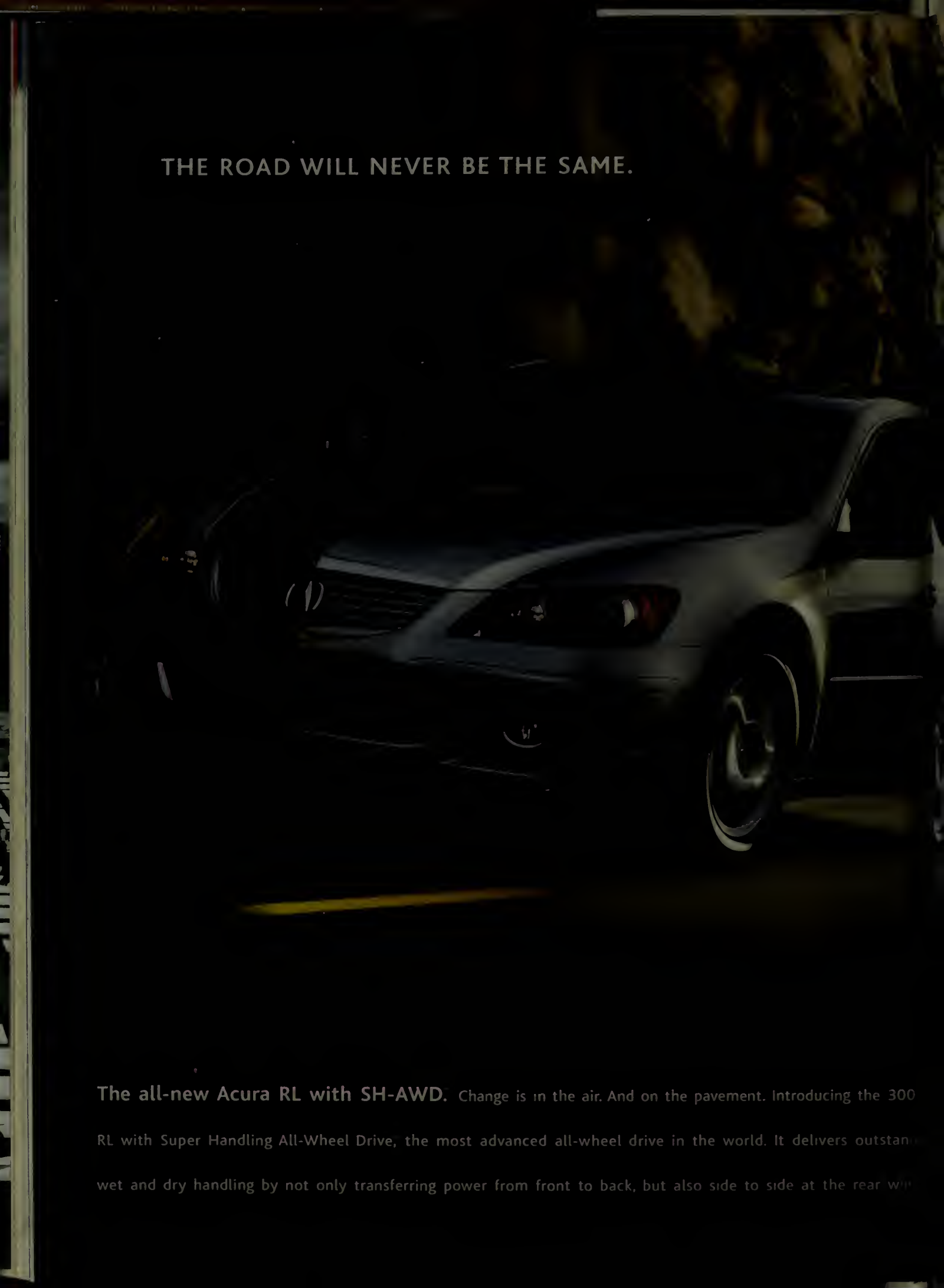
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David inside
a Sikorsky
Marine One
prototype



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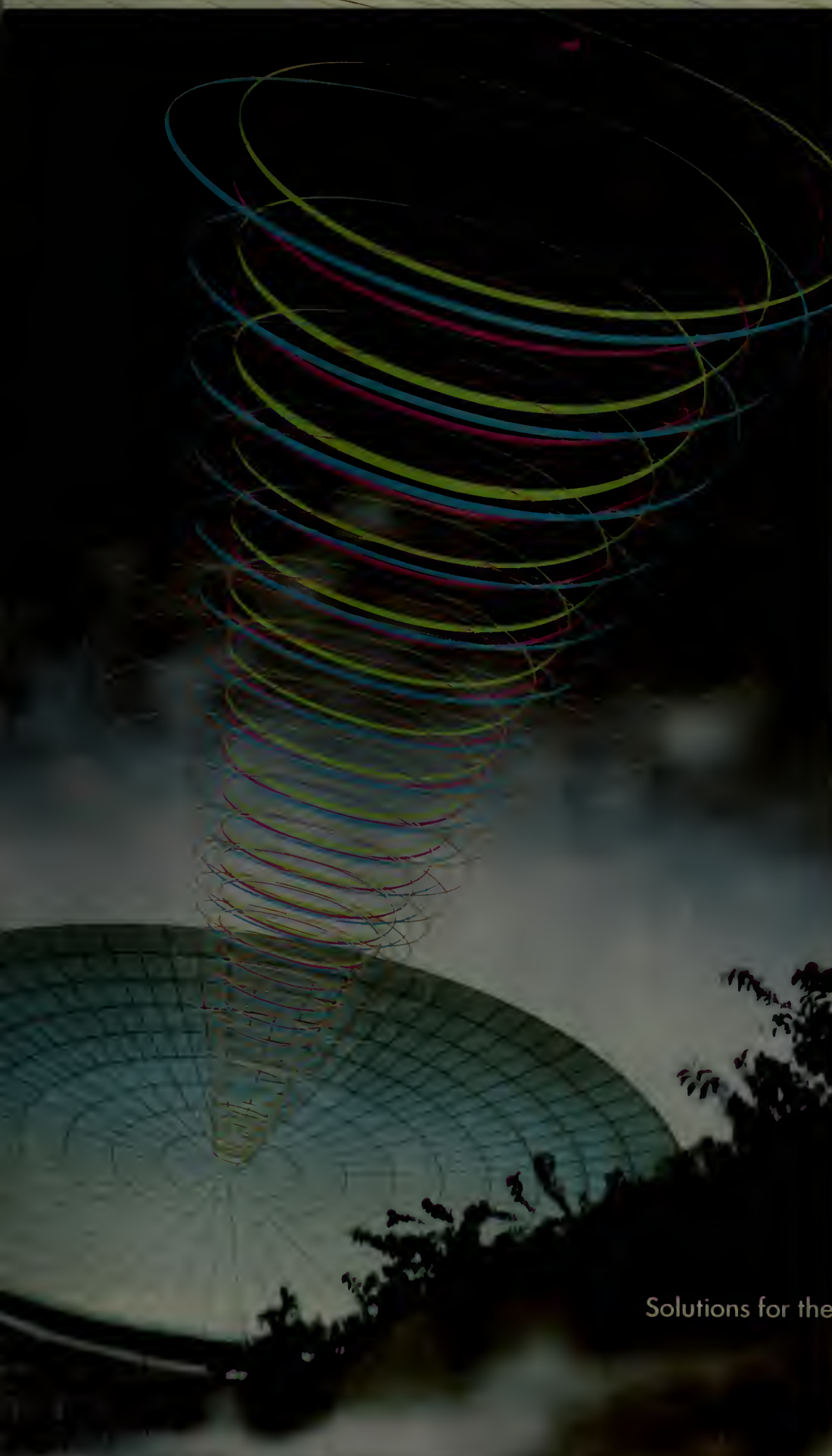


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The small that acted like a slingshot

Avaya, a global leader in communication software, systems and services, spun off from Lucent with a legacy IT infrastructure that, while efficient, wasn't nimble enough to be a competitive advantage. HP partnered with Avaya to implement IT Service Management and HP OpenView, effectively re-deploying existing technology assets. Today, IT spending is down 30%. Millions have been saved by finding unused capacity. And Avaya answers whenever opportunity calls.

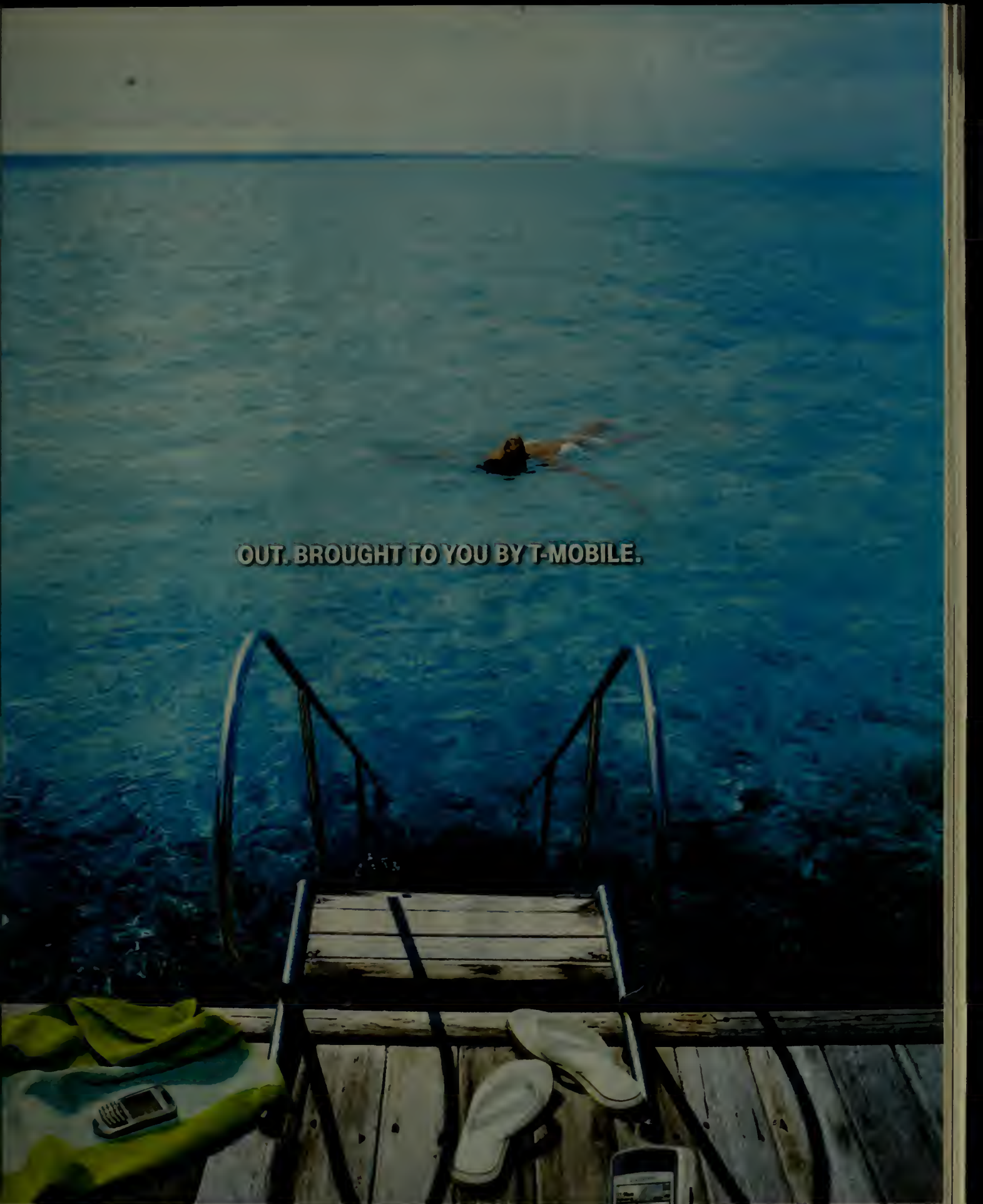
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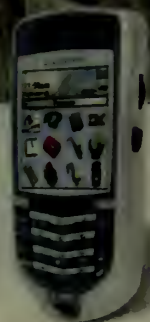




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Jeff came with:

The impression that all
financial advice was the same.



Merrill Lynch

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A team of financial experts, with a dedicated single point of contact.

A Financial Foundation[®] plan that considers mortgages, loans and retirement as well as investments.

Advice that's built on our ongoing Wealth Management Process, not a one-time consultation.

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"HENDRICK'S" WON

THE GIN CATEGORY...

- THE WALL STREET JOURNAL

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FRIDAY, AUGUST 25, 2003 - VOL. CCLXII NO. 43 - ***** \$1.00

When it came to our tasting of "white goods," the superpremiums ruled the day. Here, our top three in each category, plus our tasters' comments:

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Tanqueray No. Ten Smoothest
\$26/750ml

Juniper Green Organic Best
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Technology Special Report: Alternative Energy Powers Up

From hybrid autos and solar panels to fuel cells and beyond, sources that don't rely on oil are fast going from fringe to mainstream. Plus: Zero-energy homes, and converting livestock waste to fuel



Yahoo! Aims to Get Personal

After the biggest makeover of its site in two years, co-founder Jerry Yang says that's just the beginning. To stay ahead of powerful rivals like Google and upstarts like Snap, the Web portal is stressing features customizable to suit users' individual needs

Bush or Kerry: Who Will Be The Consumer President?

Depends on how you look at it, because each candidate comes at consumer concerns from very different starting points. Here's a primer on how they match up on three key issues

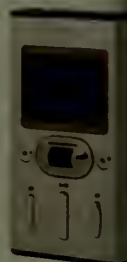


Where Opera Is Out-Browsing Explorer

Says Jon von Tetzchner, CEO of the Norwegian browser maker: "We're beating Microsoft by a 10 to 1 margin in [cell] phones." And with increased security concerns about Internet Explorer, downloads of the perennial third-place browser are climbing

To Waltz Past Apple, What Dell Needs Is a Jazzier DJ

Its attempt to unseat the iPod is falling way short, so a spiffy new player would help this holiday season. The question is, will Dell have one?



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JP Front

"This is an abuse of the public trust."

—FCC Commissioner Michael Copps, criticizing a Sinclair Broadcasting Group move to force its stations to air an anti-Kerry documentary

EDITED BY IRA SAGER

LIBRIS MAYBE THEY'LL CALL IT STARBUCKS

STARBUCKS IS getting back to publishing. Having been rebuffed by the unsuccessful launch of its own magazine, in 1999, the Seattle gourmet coffee giant is trying to break into the children's book business, *BusinessWeek* has learned. Starbucks will publish its first offering, a children's

holiday story called *The Biggest Gift of All*, by Lily Small. The \$13.95 volume will be available at 800 Starbucks stores beginning Nov. 10. "We have been interested in self-publishing for a while," says Chairman Howard Schultz.

So far the children's book is Starbucks' only offering. If it's successful, the company could publish more. That would further expand the business beyond coffee and food. Starbucks is already planning a nationwide rollout of new digital music offerings it has been testing in the Seattle area.

If their move into the music arena is any indication—an album of song duets featuring the late Ray Charles is in the Top 10—Schultz & Co. may be ready to give their customers even more reasons to hang out at Starbucks. —Stanley Holmes



WEB WATCH

Now That's Plug and Play

COULD CONNECTING TO THE INTERNET be as easy as flicking on a light switch? On Oct. 14, the **FCC** was expected to give the go-ahead to rules that will let consumers get broadband access through the electric outlets in their homes. Since electricity travels over low frequencies, utilities can use higher ones to send data. The agency hopes that broadband over power lines will give consumers an alternative to cable and telco services.

The technology also could provide another way to make phone calls. **AT&T**, **MCI**, and other Bell rivals are eager for the utilities to sell them broadband access so they can offer voice-over-Internet phone service to compete with the local phone giants. Atlanta-based **Southern Co.**, one of the largest utilities, says it's considering offering wholesale broadband service and is running trials in Hoover, Ala.

Other utilities will offer consumers broadband services themselves. **Current Communications Group**, a Germantown (Md.) startup, has a pilot service with Cincinnati utility **Cinergy**, charging slightly less than cable operators—\$29.95 to \$35.95 a month. Now power companies can light customers' homes and their computers, too.

—Catherine Yang

THE BIG PICTURE

GLOBAL TEST Executives around the world were asked to rate the strength of their own country's public institutions vis-à-vis corruption, consistent laws, property rights, etc. The U.S. scored well overall but suffered from a perception that government officials play favorites.



Source: The World Economic Forum's 2004 Executive Opinion Survey of 30,000 business executives. A perfect index score is 7.

NUMBERS GAMES

IT'S DARKEST BEFORE THE CORRECTION

JUST HOW DOWNBEAT are U.S. chief executives? The **Business Council**, a collection of 125 business luminaries, raised eyebrows on Oct. 6 with its surprisingly pessimistic growth forecast. The survey of its members, including A.G. Lafley of **Procter & Gamble** and Jeffrey Immelt of **General Electric**, showed 70% of the group forecasting flat to 2% gross domestic product growth in 2005—much more anemic than most economists expect. Then, on Oct. 12, the

Business Council released a revised forecast, saying that 70% actually call for 2.1% to 4.5% growth.

The original forecast surprised at least two members of the group, Business Council Chair Charles Holliday Jr., **DuPont's** CEO, and Rick Wagoner Jr.,

General Motors' CEO, who have expressed more optimistic views. Turns out some survey responses were put into the wrong spreadsheet column, throwing off the data.

Who prepared the report? **Fannie Mae** Chief Economist David Berson.

"Fortunately, I have nothing to do with the accounting" at Fannie Mae, jokes Berson. At least he has a sense of humor. —*Brian Hindo*



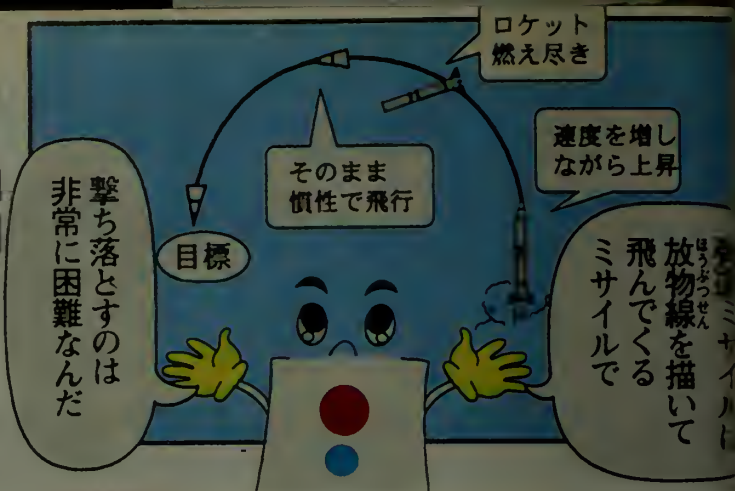
OOPS Relax, says Berson—it was just a spreadsheet mixup

COMPLIANCE

SARB-OX: MAY AS WELL START NOW

PUBLIC COMPANIES have complained about the high cost of compliance with the Sarbanes-Oxley Act. But a recent survey of CFOs at privately held companies from **Baruch College** and **Financial Executives International** shows that 60% are voluntarily enacting at least some aspects of Sarb-Ox.

Why the compliance? Most of the CFOs say it's a better way to run a business and believe Sarb-Ox will eventually apply to private companies. What's more, "stakeholders should be treated like public investors," they say. Now that's the spirit. —*Brian Hindo*



COMICS

ON MANEUVERS How do you get young people in a largely pacifist nation to care about what the military is up to? In Japan, the answer is a manga comic book. On Oct. 8, the Defense Agency, which oversees the country's military, released a comic book version of its annual **White Paper** outlining Japan's defense policies. The 24-page comic follows the exploits of Mirai, a college student, as she gets a tour of the armed force's history, its role in Iraq, and legislation to give it a freer hand in defending Japan. The \$3 comic is unlikely to be a best-seller. But in a country where comics about the likes of Nissan CEO Carlos Ghosn have sold well, who knows?

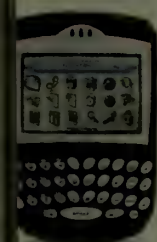
—*David Rocks and Hiroko Tashiro*



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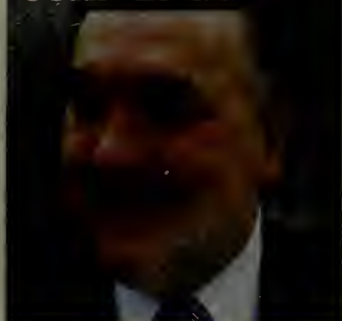
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FACE TIME

JOHN ENGLER



HELPING U.S. FACTORIES FINISH FIRST

When Michigan ex-Governor **John Engler** took office in 1991, the state was in a manufacturing downturn, business costs were high, and regulations were stifling. Engler took bold steps: In 12 years he cut taxes by \$21 billion, pruned environmental regs, and cut welfare.

So when the 12,000-member National Association of Manufacturers went looking for someone to head its lobbying effort, Engler, a Republican, seemed perfect. His top priorities: cutting the tax, health-care, and regulatory burden on manufacturers and bringing accountability to a public school system that, says Engler, has failed to produce the workers the sector needs.

It's a tough job with small manufacturers viewing China as a threat and large companies embracing it as a chance to move offshore: "There is a mediating role for me, sorting out the differences among companies," he says. Getting Congress' warring tribes to back an NAM agenda may be easy by comparison.

—Paul Magnusson

VIRTUAL FUTURE

A DEEJAY YOU CAN DOWNLOAD

FINALLY GETTING a handle on blogs? Get ready for the next wave: podcasting. In the past three weeks the blogosphere has been buzzing about software that enables do-it-yourself radio. Since Sept. 28, the number of listings that mention podcasts on **Google** has jumped from 24 to nearly 14,000.

What is podcasting? It is a free audio show that anyone can subscribe to for listening on a mobile device, such as an MP3 player or an iPod (hence the name). Here's how it works: A show is created using Really Simple Syndication (RSS)—free publishing software that zaps files to users without their visiting a Web site. The software is used now by blogs and mainstream



companies such as the online edition of **The New York Times** to send out news updates. A show is broadcast to subscribers' PCs, so it can be downloaded at their convenience to a mobile device.

Podcasting is the latest example of how grassroots technology is getting around big media. Three months ago blogger and former **MTV** host Adam Curry created iPodder software using RSS that can download and play audio

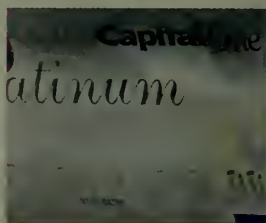
shows on a music player. Now there are podcasts on everything from rock 'n' roll to politics. **WGBH**, an **NPR** station in Boston, is using podcasts for an interview show. As more companies adopt RSS, they, too, could turn to podcasting. "Personalized media is the next frontier," says Charlene Li, an analyst at **Forrester Research**. From blogs to podcasting, it's a frontier that keeps expanding.

—Heather Green

TOTAL RECALL

SLOGANEERING Quick! What's Miller Beer's ad slogan? How about Kmart's? If you can't recall, you're not alone. Only 1% of those asked by Atlanta marketing consultancy Emergence knew the answer. Allstate's "You're in Good Hands" scored tops, with 87% recognition, but it's 49 years old so you can't help but remember. Soft drink, fast food, and beer brands rely on ads to shift market share and drive store traffic. Yet Wendy's scored zero after more than two years with "It's Better Here." Coca-Cola's 18-month old "Real" hit just 5%. But McDonald's, "I'm Lovin' It" did a respectable 33%. Match the brand and slogan (below), then go to businessweek.com/magazine/extra.htm for more brainteasers.

—David Kiley



CAPITAL ONE

- A** The Only Card You Need
- B** What's in Your Wallet?
- C** Give Us Your Wallet



SPRITE

- A** Obey Your Thirst
- B** Refreshment Every Day
- C** What's Your Pleasure?



HEINEKEN

- A** The Beer To Have When You're Having More Than One
- B** It's All About the Beer
- C** As Good As It Gets



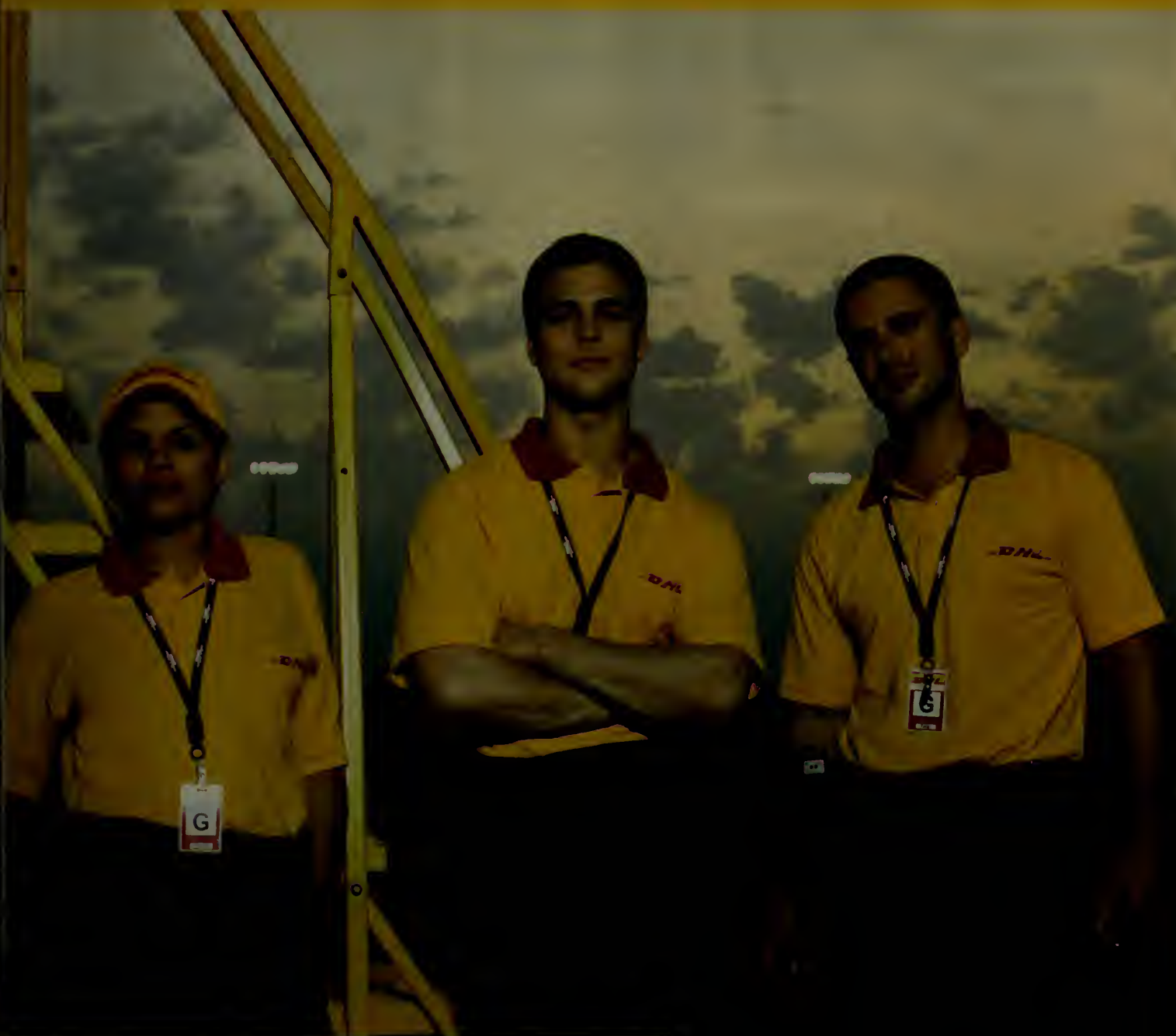
CHRYSLER

- A** Inspiration Comes Standard
- B** That Thing Got a Hermi?
- C** The American Classic

Answers: 1.B 2.C 3.B 4.A

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The Great Innovators

CELEBRATING

75

As part of its anniversary celebration, BusinessWeek is presenting a series of weekly profiles of the greatest innovators of the past 75 years. Some made their mark in science or technology; others in management, finance, marketing, or government. For profiles of all the innovators we've published so far, and more, go to www.businessweek.com/innovators/

Management Evangelist

JOHN F. WELCH JR. did not invent Six Sigma or many of the processes that made him famous in the 20 years that he led General Electric Co. But the relentlessly curious and blunt guy from Peabody (Mass.) imbued his corporation with an energy and culture that made it—and him—an icon of American business.

Through his own proselytizing personality, penchant for pithy slogans, and a rigorous performance system that demanded every manager become a mentor, Welch turned a disparate conglomerate into a global teaching organization. He understood that great talent was at least as important as great products. In the process, he showed how a vast, complex company could stay nimble and hungry even as it dominated rivals.

Welch, who joined GE in 1960 with a PhD in chemical engineering and became CEO in 1981, held few things sacred. He regularly jettisoned nonperforming units and was famous for annually lopping off the bottom 10% of his managers. But Welch made it his mission to manage and foster top talent with hawk-like attention. Every April he would clear his agenda to visit each business and review the performance of thousands of high-potential employees through a grueling process known as Session C. Up-and-coming leaders were moved around the 300,000-strong company and judged, among other things, on how well they were leading and nurturing others. Welch would prod and praise them, sending out a flurry of handwritten notes, or champagne to spouses, for a task well done. "Jack put his time and energy into developing people," says Noel M. Tichy, the University of Michigan management professor who helped Welch revitalize his Crotonville training center in New York's Hudson Valley. The center annually draws more than 8,000 employees for leadership training alone. Welch

Under Jack Welch, GE developed the deepest bench of executive talent in U.S. business

transformed routine meetings into rousing debate sessions and launched initiatives such as the Six Sigma quality process and the Workout approach to team problem-solving that touched practically every employee around the planet.

As a result, GE developed what many consider the deepest bench of executive talent in American business. In the years leading up to Welch's retirement in 2001, he helped to develop several contenders for his job. When Jeffrey R. Immelt was chosen, the losers immediately became chief executives at 3M and Home Depot Inc. Contrast that record with the succession angst that has played out in other American icons such as Walt Disney

Co. and Coca Cola Co.

Welch had his weak spots. His talent hunt seemed to capture mostly white men, with few minorities and women in the upper ranks. His fierce resistance to cleaning up the toxic chemicals that GE had dumped into the Hudson River between the 1940s and mid-1970s also did little to enhance his reputation as a model corporate citizen. Even his lavish retirement perks, which Welch and GE insist were justified, look ill-considered in today's transparent corporate climate.

But Welch-style training programs are as popular as ever. Shanghai now boasts its own Crotonville-style facility and GE's management prowess still inspires envy. Cultivating top talent is part of the GE brand, with competitors worldwide striving to mimic the systems that Jack built. ■

—By Diane Brady



The more visible
you make your
supply chain,
the less vulnerable
it becomes.

The logo features the text "3D Visible Enterprise" in a sans-serif font. The "3D" is in a large, bold, red font, while "Visible Enterprise" is in a smaller, white font. Above the text is a graphic of three overlapping, semi-transparent diamond shapes, each with a white outline, creating a 3D effect.

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Asking to simplify a cash-flow statement is [like] asking a neurosurgeon to simplify brain surgery."

—Jim Guilfoyle
 Cummins Inc.
 Columbus, Ind.



BRINGING FINANCIAL STATEMENTS INTO FOCUS

AS CHAIRMAN of the Financial Accounting Standards Board (FASB), I agree with the main thrust of "Fuzzy numbers" (Cover Story, Oct. 4)—that further significant improvements are needed in corporate financial reporting and disclosure. As evidenced by our very full agenda at the FASB, this includes the accounting standards in a number of areas.

You correctly point out the importance and necessity of the use of judgment and estimates in accrual accounting and the challenges they pose for investors and others seeking to understand and use reported financial information. Existing accounting standards and Securities & Exchange Commission rules require extensive disclosures in many areas involving the use of estimates. Somewhat surprisingly, the article does not discuss the key role that the required Management's Discussion and Analysis is supposed to play in highlighting "critical accounting estimates."

Recent and proposed accounting standards directly address many of the issues cited, including accounting for restructuring costs, fair value measurements,

and enhanced disclosures on pension costs and on the impact of mergers and acquisitions on reported results. Other suggestions you mention are being considered in our major project with international standard setters to revamp income and cash flow statements. With regard to the recommendation that FASB revise the periods presented in quarterly and year-to-date financial statements: SEC rules cover such requirements.

—Robert H. Herz, Chairman
 Financial Accounting Standards Board
 Norwalk, Conn.

SPOT-ON WITH "Fuzzy numbers!" It is not your first story showing how erratic the annual and quarterly profit figures are. When will we learn that the more capital-intensive and the longer the time frame for investments, the fuzzier are the reported periodical earnings? Audited, generally accepted accounting principles (GAAP) earnings have so little meaning left that, even without deliberate fraud, they remain misleading. Is there an alternative? Yes. Companies are already forecasting cash flows. Aren't these more relevant than current profit reports? Why not require companies to publish a range

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Readers Report

CORRECTIONS & CLARIFICATIONS

"Top of the world" ("The best B-schools," Cover Story, Oct. 18) should have noted that the Queen's University at Kingston (Ont.) MBA for Science & Technology program has a maximum of 78 students, not 90.

"Scouring the planet for brainiacs" ("The innovation economy," Special Report, Oct. 11) mistakenly implied that IXI Mobile Inc. was spun off of Israel's military. IXI, whose headquarters are in the U.S. although most of its R&D is done in Israel, says there is no military connection.

discounted cash flow (DCF) values with list of assumptions as well as the tools to vary the DCF value if the assumptions vary? Accounting standards can be achieved if auditors verify the validity of the forecast systems, check for biases—intentional or not—and show how the figures are quantified. It is still a forecast and nobody will be deceived into thinking it is absolutely accurate. A regular post-mortem will allow investors to judge the managerial ability of the executive. Current financial statements don't do that.

Reported profits have been shown to be too arbitrary and too easily manipulated and certainly not directly relevant to investors. This defeats their purpose. It is about time our primary investment tool could be well-researched forecasts published by each company. Let us scrap these fabled fuzzy profit reports.

—Alfred Gans
Brisbane, Australia

AS A PREPARER of financial statements for the past 16 years, I read "Fuzzy numbers" with great interest. Asking to simplify a cash-flow statement is somewhat analogous to asking a neurosurgeon to simplify brain surgery. Companies do transactions and issue financial instruments that didn't even exist 16 years ago, when the current format was introduced. They're also more global, introducing currency translation. Updated guidance on the treatment of these new instruments and a revisit of the definition of a cash equivalent may indeed be needed.

Every manufacturing company should be required to disclose operating earnings with better clarity and stricter guidance on what goes into operating earnings. The SEC should revisit the S-X rules related to the income statement and tighten the rules on what should be disclosed and condensed.

I also agree with Robert Herz, who

does not want to force more rules and regulations on the preparers due to all the new requirements from FASB, SEC, and Congress that we are currently trying to implement. Quite frankly, Sarbanes-Oxley has sucked all the oxygen out of the room in this regard. We are very tired.

—Jim Guilfoyle, Director
Corporate Accounting, Consolidation,
and External Reporting
Cummins Inc.
Columbus, Ind.

THERE IS A CRITICAL NEED to make sure corporate reporting is understandable and readily comparable within the same industries. Moreover, corporate reporting needs to be more relevant to investors and simplified to eliminate redundant and stale requirements. Enhanced Business Reporting is one of the answers to the problems raised in the article that does not require new laws or regulations.

—Mike Starr
Grant Thornton LLP
Chicago

COULD DAVID HENRY not have found one company that adheres to best practices and successfully improved or maintained transparency in financial reporting? Among the members of Financial Executives International are chief financial officers who insist on unbiased, reliable, and verifiable representations of events that can be readily compared with other periods and other companies. They write in plain English, without jargon, and distill lengthy statements into clear, concise tables understandable at a glance.

—Colleen Sayther Cunningham
President and CEO
Financial Executives International
Florham Park, N.J.

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Sea Change at the World Bank

THE WORLD'S BANKER A Story of Failed States, Financial Crises, and the Wealth and Poverty of Nations
By Sebastian Mallaby; Penguin Press; 462pp; \$29.95

Let's see now. World Bank President James Wolfensohn is an egomaniacal tyrant who sends bank vice-presidents to fetch his luggage and his female chief of staff to bring him coffee. He terrorizes executives in the hallways of the bank's lavish headquarters by asking: "Are you still here?" Thin-skinned and insecure,

he meets criticism with rage. Unable to share credit, he passes off the work of others as his own while fantasizing about winning a Nobel Peace Prize.

Or perhaps Wolfensohn is a visionary leader who realizes that to rescue the 3 billion desperately poor people of the world, he must shake up the inefficient and cynical institution. He has selflessly given up the huge riches of the boutique investment bank that he founded in order to attack the scourges of hunger, disease, and poverty. A gracious host and talented charmer, he employs his own \$400 million fortune and vast Rolodex of the world's wealthy and powerful to pursue his admirable aims.

Actually, Wolfensohn comes across as both characters in *The World's Banker: A Story of Failed States, Financial Crises, and the Wealth and Poverty of Nations* by Washington Post columnist Sebastian Mallaby. But this readable book is much more than a portrait of a contradictory and complex character. It also offers a provocative account of Wolfensohn's two five-year terms—the second is just about to end—that bookmark an intense period of change in the World Bank's 60-year history.

As Wolfensohn took over in 1995, the bank was deeply troubled: Its professionals were "arrogant," its loan terms were "cruel," and its projects too frequently failed, says the author. With its \$20 billion-a-year loan portfolio, the bank imposed vast dam and water projects on the Third World without regard to their effects on the environment or indigenous people. One 1980s project in Brazil destroyed 50,000 square miles of Amazon rain forest, an area about the size of Wisconsin.

The bank insisted on "structural adjustment" of the economies of fragile nations that were already struggling to repay loans long since stolen or squandered by corrupt dictators. It demanded repayment no matter what the cost: In the mid-'90s, Uganda spent \$2.50 per capita for health care and \$30 per citizen on debt repayment. Impoverished nations were forced by bank policies to borrow to service the old debt in a spiral that made no sense. Meanwhile, even during the

early '90s, less than 1% of the Bank's loan portfolio went toward fighting AIDS.

As an energetic outsider, Wolfensohn could see these flaws even if he couldn't always fix them. He wisely insisted that the bank's highly educated but intellectually insular staff open itself up to the nongovernmental organizations (NGOs) that World Bankers dismissed as "no-gos." From the outside, NGOs such as Oxfam and CARE successfully began to pressure the bank to change even as Wolfensohn pushed from the inside. Consequently, the bank hired environmentalists and anthropologists and brought borrowing nations in on decision-making. To fight the graft and corruption among African governments and hold local officials accountable, the bank made the whole loan process transparent, even telling parents how many new classrooms they should expect to see.

The link between bank and NGO was a successful collaboration for a while. But sometime in the late 1990s, argues Mallaby, Wolfensohn swung the bank from arrogance to timidity, allowing the institution to be pushed around by the more radical groups. Mallaby details how environmental outfits eventually delayed and quashed dams and pipeline projects in China and Chad by frightening the bank away from seemingly justifiable investments.

In this, Mallaby himself is guilty of a little NGO-bashing. These "civil society" groups are, after all, not some nefarious conspiracy but usually grassroots organizations whose support grows out of a perceived need among the general public. Sure, some of the rhetoric of

Friends of the Earth and its brethren is ill-informed and unscientific, but that's democracy, bro. Mallaby also errs by insisting that "nobody saw what was coming in Seattle" when the World Trade Organization talks collapsed as thousands protested in the streets. In fact, the WTO—a sister organization to the bank—had already splintered

as developing nations refused to swallow more trade-liberalization nostrums. It wasn't the NGO members in turtle costumes who ended the talks. It was Brazil, Egypt, and India—leading the poorer nations of the world to outvote Europe and the U.S.

Still, *The World's Banker* is an engrossing story. At its heart is a fascinating character and a lively retelling of the tortured history of an important institution that almost no one understands. ■

—By Paul Magnusson



Wolfensohn: Egomaniacal tyrant or compassionate reformer?



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BY STEPHEN H. WILDSTROM

Software for the Ultimate Couch Potato

Depending on how you think about it, the Media Center PC is either a computer that doubles as a television in an office or dorm room or the core of your home entertainment center. With the release of a new version of Windows XP Media Center Edition on Oct. 12, Microsoft has made its vision clear: It wants to take charge of home entertainment.

Media Centers are high-end PCs equipped with a TV tuner and a version of Windows that adds a program guide, the ability to record shows to the hard drive and to copy the recordings to DVD, and other entertainment-oriented goodies. These capabilities are wrapped in a user interface that lets you hold a TV-style remote while seated across the room and operate the TV and DVD player, show pictures, or play music. While there have been major enhancements, especially in TV quality, since the Media Center appeared two years ago, the basic features haven't changed much. But PC makers, working with the new edition of the software, have added multiple TV tuners, so you can view one show while recording another. You can also watch and record high-definition television, but only over-the-air broadcasts, not cable or satellite. (For more on HDTV issues, see www.businessweek.com/technology/.) The most important addition may turn out to be the Media Center Extender, a device costing \$300 or less that lets you send content from a Media Center PC to TV sets in your house. (I'll take a detailed look at the Extender next week.)

MEDIA CENTERS COME IN THREE TYPES. Most are standard desktop PCs with added entertainment features, such as the Dell Dimension 8400, which starts at \$1,138, including a 17-inch CRT. Dell plans to make Media Center features optional on all of its home desktops. These features range from audio-only offerings in PCs lacking the processing power to handle TV to high-end desktops with three built-in tuners. You can also get a Media Center notebook from Hewlett-Packard or Toshiba. In fact, Toshiba has created a brand, Qosimo, dedicated to Media Center laptops, starting at \$2,599 for a model with a 15.4-in. wide-screen display. But the most interesting models are PCs, such as the superquiet Alienware DHS I tested (starting at about \$1,700), that are designed to look like part of a home-entertainment system.

The newest Media Centers can handle up to three tuners: two for standard television and one for over-the-air digital TV.



SUPERQUIET
Alienware's
DHS starts at
\$1,700

A Windows Media Center can now handle three tuners

while sitting on a sofa, or what Microsoft calls the "10-foot interface." In this sort of setup, the Media Center PC is overkill, since there's an awful lot of Windows—and a lot of hardware devoted to it—that sits idle. And yes, your Windows-powered TV may crash. But while other companies have tried to market simpler devices, nothing I have seen has come close to Microsoft in terms of integration or ease of use. In fact, most of the products I've looked at remain stuck in trials or have died without ever reaching the market. And no one has anything like the Media Center Extender.

After years of hassles with Windows, I wasn't eager to let it take over my TV. But the fact is, Media Center and the Extender do the job—and do it well. ■

E-mail: techandyou@businessweek.com

The goal is to allow simultaneous recording and live viewing, or to let you watch two different live and recorded programs—one on the Media Center and one on a set

in a different room using an Extender. Setting up a show for recording is a simple matter of selecting it on the electronic program guide and clicking record on the remote. Saving recorded shows to DVD is also easy. As for viewing, you can watch on a computer display

or use a variety of outputs to connect the Media Center to standard TVs, or to the latest wide-screen digital displays and surround-sound audio systems.

All Media Centers are full-fledged Windows XP computers. But computer makers say that many Media Centers, especially those designed for living rooms, nearly always involve clicking a remote from across the room

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BY GLENN HUBBARD

When It Comes to Jobs, Kerry Is Way off Base

It is often said that our work defines who we are. It's not surprising, then, that election-year ruminations on the economy are focusing on jobs and incomes. The usually unassailable position that flexible labor markets are essential to long-term growth is being questioned by Senator John Kerry through his opposition to outsourcing and the CEOs who do it. He is also

raising serious questions about the notion that long-term growth acts as a rising tide to lift all boats.

Let's start with the obvious: For the U.S., growth is a normal state of affairs. Over the past 25 years, except for short recessions and brief periods immediately thereafter, the American economy has generated sufficient opportunities to offer jobs to both new entrants to the labor force and those who have lost jobs. These fresh opportunities raise total employment and lower the unemployment rate, as has been the case in the U.S. for over a year.

THE FLEXIBILITY IN THE ECONOMY IS NOT THE ENEMY of job creation. Flexibility helps generate more productivity growth—more output for a given labor input. Since 1979, U.S. labor productivity has increased by an astonishing 67%, while 40 million jobs have been added. These gains in productivity growth and employment do not imply that no jobs are lost. Job losses resulted from global competition, changes in buying patterns by consumers and businesses, and corporate reorganization. But nimble markets for risk capital and new industries created many more jobs than were lost. This dynamism is a hallmark of U.S. economic success.

Indeed, an economy with rigid job protections, limits on competition, and restrictions on risk capital would have lower productivity growth and a diminished ability to generate new jobs. One need only think of the French and German experience over the past decade as a guide to where anti-growth, anti-risk-taking policies can take us.

And what about the rising tide? We hear much about the "middle-class squeeze." While the economy has created more than 1 million jobs so far this year, we're told by Senator Kerry that the positions are low-paying. Recent research by the Economic Policy Institute observes that, while real family incomes have generally increased over time, they were stagnant for 2001 and 2002. That's true, but since then the economy has rebounded. The 4.8% growth in real gross domestic product over the past 12 months is faster than in any such period during the Clinton years. This growth will be felt in rising incomes in the months ahead.

And data on consumption—a better measure of how well-off people are than is current income—indicate a continuing

increase in families' resources. The federal government's Consumer Expenditure Survey tells us that real consumption of the middle 20% of U.S. households increased by two percentage points over 2001 and 2002, and by 10% since 1984. Where's the squeeze?

It's instructive to compare the state of the job market now with the the last time a President ran for reelection. In 1996 approximately 5 million individuals reported that they were working part-time but wanted to work more. This year that number is down to 4.3 million. Over the past four years the growth rate of real average hourly earnings has been 2.9%, vs. -0.5 percent during President Clinton's first term.

Over time, gains in incomes from the factors driving

Flexible labor markets are the key to higher income and growth

productivity growth and job creation accrue to middle- as well as upper-income households. The same contributing factors of flexible labor and capital markets can explain the upward mobility of many middle-income workers.

Political scare-mongering about the health of U.S. jobs and income is misguided. President Bush's proposal for Personal Reemployment Accounts offers individuals likely to be unemployed for an extended period of time a

lump-sum payment in an account to be drawn down to defray training or health-insurance costs. The balance could be retained in the account if one finds a new job quickly. In contrast to a costly expansion of unemployment insurance, Personal Reemployment Accounts would enhance labor-market flexibility and support individuals seeking to switch careers in an ever-changing economy.

President Bush and Senator Kerry offer radically different views on a core economic issue. And it's not just the President's job that depends on the choice. ■

Glenn Hubbard is dean of Columbia Business School. He chaired the Council of Economic Advisers from February, 2001, to March, 2003, and remains an informal White House adviser.

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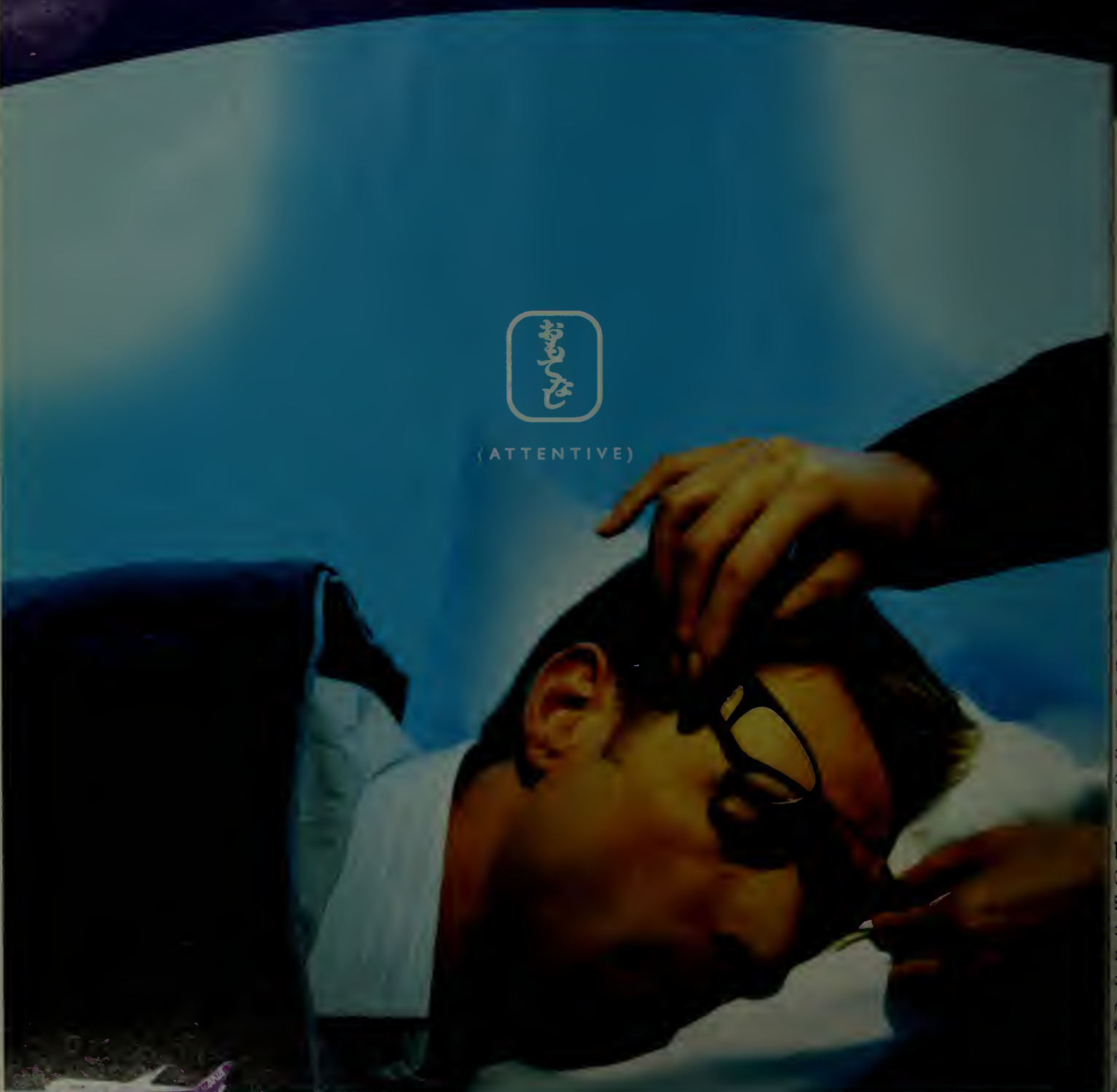
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ROLEX OYSTER PERPETUAL DAY-DATE

BY JAMES C. COOPER & KATHLEEN MADIGAN

A Tempest in Employment's Teacup?

Here's who softened September's job numbers: Frances, Ivan, and Jeanne

U.S. ECONOMY

How much stock should you put in the September jobs report? The latest data from the Labor Dept. were certainly a surprise to almost everyone from the White House to Wall Street, and probably to the Federal Reserve. Nonfarm payrolls grew by 96,000 jobs last month, far less than the 150,000 expected by economists. The

breadth of hiring was much narrower than in the spring, and the unemployment rate remained at 5.4%. But focusing on the headline-grabbing payroll number takes attention away from two key points regarding the labor markets and the economic outlook in general.

First, the recent lackluster job numbers may be saying more about the weather than the economy. Four hurricanes hit Florida and other states during August and September. With skies now a lot clearer in the Southeast and rebuilding under way, the October job report could post a reassuringly strong payroll gain.

Second, structural changes in the economy suggest the U.S. has entered a new era, where strong output translates to merely modest job gains (page 38). Not only could such a shift mean a reassessment of how inflation pressures build or what drives Fed policy decisions, it could also redefine what constitutes a strong job market in the years ahead.

Right now, however, the recent disappointing job news comes at a time when the threat from rising energy prices is gotten worse. Crude oil priced at more than \$50 per barrel is lifting gasoline and heating oil costs, and the squeeze on household budgets will be greater than anticipated only a few months ago. Consumer spending could be at risk, if not in the fourth quarter, then in early 2005. At its current pace, job growth would not be sufficient to generate the income growth needed to keep households spending at a solid clip.

WHAT'S WHY the latest job data were eagerly anticipated by economists, policymakers, and investors. The neck-and-neck Presidential campaign added to the urgency.

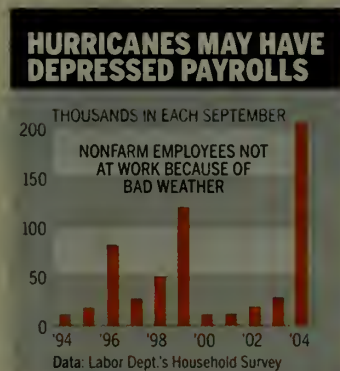
Bear in mind that the reported payroll gain deviated from the expected increase by a relatively small 50,000 workers in a payroll total of 132 million workers. The Labor Dept. said the hurricanes did not have a significant effect on its assessment of September employment, but some of Labor's data, both published and unpublished, suggest the impact may well have been large enough to cause the job shortfall—and more.

First, Labor's data from individual states on weekly initial claims for jobless benefits certainly showed a weather-related impact. Claims rose sharply in the

second half of September and then fell back in early October, most notably in the affected states.

Second, Labor tracks the number of people who miss work due to bad weather. These unpublished tallies are from Labor's survey of households, which is separate from its more widely followed count of company payrolls. Excluding agriculture, since farm jobs would be expected

to show a disproportionate hit, the nonfarm numbers spiked in September. The data are not adjusted for seasonal patterns, but last month's level of 205,000 was the highest for any September since Labor began keeping records in 1976, and far above the 120,000 in September, 1999, when Hurricane Floyd hit (chart).



Other unpublished data from the household survey corroborate that spike. Labor also adds up the number of full-time workers who are working part-time. Those data also show an outsize increase to 1.9 million compared to past Septembers. The last unusually large reading was, once again, during Hurricane Floyd.

Accurately translating these data into the company survey numbers is impossible, but the pattern of payrolls during Hurricane Floyd offers some guidance. Based on the originally reported data, payrolls in September, 1999, dropped by 8,000 after averaging gains of 230,000 per month that year. In October, 1999, employment bounced back up by 310,000. To the extent that the hurricanes dampened payrolls last month, the Floyd example suggests that October employment could rebound strongly.

BECAUSE THE HURRICANES HIT a broad swath of the U.S., it is hard to separate their effects from any evidence of real weakness in specific industries. The September report did show that manufacturing jobs fell by 18,000, after factory payrolls had been trending upward so far in 2004. Retailers shed almost 15,000 jobs last month, while

the information sector pared 12,000 off payrolls, most of them in the telecommunications industry.

On the plus side, however, were job gains in professional and business services, education, and health care, along with the hospitality sector. Public school jobs also posted a big increase, but again that may be weather-related, as some Southeast states had to begin their school years later than normal, a factor that may have distorted the seasonally adjusted results.

ONE SIGN THAT JOB GROWTH may not be as slack as the top-line number suggests comes from the fact that wage growth has accelerated after hitting a low in the first quarter. In September, hourly pay for nonfarm production workers was up 2.4% from a year ago, better than the 1.6% clip posted in February (chart). The pickup was seen in both manufacturing and service paychecks.

The key question is whether wages will continue to grow fast enough to offset rising energy prices. Since gas prices began to rise sharply in early May, hourly wage growth and the total consumer price index have both risen by 1%, meaning that pay raises have been able to keep pace with higher inflation.

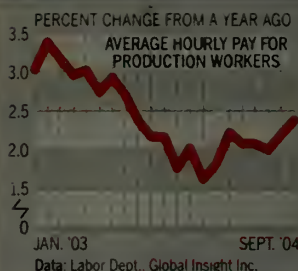
However, the expectation was that oil prices would stabilize in the second half, meaning they would not push inflation any higher. Instead, petroleum prices continue to climb. On Oct. 12, oil briefly touched a record \$54 a barrel before falling back. Oil greater than \$50 suggests further increases in gas prices, which rose an additional 5¢ to \$1.99 a gallon for the week of Oct. 11.

The risk to the fourth quarter is that consumers will have to pull back on their spending, especially for holiday gifts, to pay their gasoline and heating bills. For now, the National Retail Federation is forecasting that holiday sales in November and December will rise by 4.5% over last year's season. That's the same solid gain

posted in 2003. But consumers this year will not have tax cuts and rebate checks to help boost their spending.

Another drag on this quarter's demand may be a falloff in car sales. Without the generous incentives that lifted third-quarter sales to the highest pace this year, car buying will likely decline slowing overall spending

WAGE GROWTH HAS RISEN FROM ITS RECENT LOW



That is, unless the job markets turn around and income growth accelerates in the fourth quarter. Ever since job growth petered out in the summer after its spring surge, economists have been looking for hiring to rebound. But after the disappointing September job results and soaring oil prices, more forecasters seem less sure about that. Now, the October job report, due on Nov. 5, takes on new importance—to see if last month's letdown was real, or if it was merely the temporary impact of Frances, Ivan, and Jeanne. ■

OPEC

Where All Those Petrodollars Will Go

WITH OIL PRICES touching \$54 per barrel on Oct. 12, OPEC and other oil-producing nations are on their way to a windfall in export revenues. What will they do with their gains, and how will this transfer of wealth from oil-consuming countries to oil producers play out in the global economy?

Ultimately, oil revenues end up getting recycled back into the global economy in two ways: They can go to buy more goods and services from abroad, or they can be invested in foreign securities. For global growth, the former is preferable to the latter. The more oil producers increase their imports from oil consumers, the less oil-consuming nations will feel the shock of their lost

wealth. And that could be a plus this time, compared with past experience.

Economists at UBS Securities in London note that OPEC has shown an increasing propensity in recent years to import more when oil revenues rise. From 1999 to 2003, OPEC spent 85% of its petrodollars on imports. Excluding Iraq, which was under U.N. sanctions, the figure is about 90%. Either rate is well up from the

65% of 1979 to 1984.

Moreover, petrodollars are being recycled back into global trade more quickly than in the past. After each of the two oil shocks of the 1970s, OPEC's outlays lagged its revenues by three years, says economist John Llewellyn at Lehman Brothers Inc. But

from 1998 to 2003, he says, OPEC spending has largely kept pace with oil revenues, although the rapid rise of oil prices in 2004 will undoubtedly create some drag.

Clearly, the revenue windfall will be a boon for the governments of oil-exporting nations since it bolsters fiscal positions and helps to repay debts. For example, Russia may well be able to restore its investment-grade credit rating as a result.

But as the petrodollars get recycled, the U.S. may not see much benefit. For one thing, U.S. exports to OPEC members remain weak. Although U.S. shipments this year are up a bit from last year's level, they are down 20% from 1998. Plus, the U.S. may not gain from new capital flows. Although there are no hard data, anecdotal reports suggest that, in the current geopolitical climate, petrodollar investments are flowing increasingly to euro-based assets. ■

SO FAR, LITTLE LIFT FOR U.S. EXPORTS





Byron Wien, US Senior Investment Strategist

Putting his two Euros in.

The Smartest Man in Europe sizes up the world.

Every year I try to spend several days with someone I consider The Smartest Man in Europe.

He first got my attention in the mid-1980s by making a case for the collapse of Communism and the dismantling of the Berlin Wall, but there have been many other examples since then. His family roots in mercantilism extend back hundreds of years, to when his ancestors sold supplies to traders along the Silk Road. He continues to be sustained by the thrill of new ideas and the profit that can be made by watching them evolve. Here's some of what he had to say:

Earlier in my investment career I observed some clear patterns of economic and stock market activity and learned how to respond to them. The US economy would go into recession, the Federal Reserve would ease monetary policy to stimulate business, and the stock market would react favorably. Interest rates and inflation would then move higher, and the Fed would tighten, causing a recession and a stock market decline. Then the same thing would happen all over again.

Think about how different things are now. The economy slowed, the Fed eased significantly, the government applied massive fiscal stimulus, business picked up, but inflation remained tame and interest rates stayed low. Yet the stock market is going nowhere. The market is smarter than all of us and knows something is wrong.

The world is settling into three major blocs, and only one is especially interesting from an investment viewpoint. The first bloc is Europe, whose problems are well-known. The population is aging, the economy is mature, the continent is burdened by an accumulation of socialist policies, and the entrepreneurial spirit is dampened by regulation and bureaucracy.

The American bloc isn't much better. No politician can propose anything that involves sacrifice. The price of oil soars,

and you don't do anything to seriously encourage conservation. Your manufactured products are uncompetitive, and you don't provide the necessary incentives to expand the knowledge-based industries where you have an advantage.

Then there is Asia, which is only beginning a long cycle of opportunity. Both China and India have educated populations willing to work very hard for modest wages, and every year

China moves further along the curve of manufacturing sophistication. Most Asian countries provide few healthcare benefits, and there is no plaintiff's bar. Environmental considerations are generally a low priority. It is a free-wheeling business atmosphere much as I imagine America was in the days of the Wild West.

But most stock markets in Asia are relatively undeveloped. If Asian markets were as liquid as the United States and had regulators making sure that trading practices were fair, I would have half of my money in developing Asia. While Japan is further along the maturity scale, it is a major beneficiary of Asian growth. I think the Japanese market has a long way to go on the upside.

Byron Wien
US Senior Investment Strategist

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COMMENTARY

BY MICHAEL J. MANDEL

Jobs: The Lull Will Linger

Structural shifts across several key sectors make the robust job growth of the 1990s unlikely to return anytime soon

REMEMBER WHEN the U.S. was a big, mean job machine? The 1990s saw the creation of 22 million jobs, the equivalent of adding another California and New York to the national labor market. Even after the 2001 recession and the September 11 terror attacks sent employment reeling, most economic observers—including this one—were confident that the job slump was just temporary. In fact, the employment market didn't turn up until August, 2003, and its performance since then has hardly been riproaring. In September only 96,000 jobs were

created—the fourth disappointing month in a row. And while the economy has added 1.7 million jobs in the past year, that's still 500,000 less than the 2.2 million average annual gain in the 1990s. True, the shortfall may be reduced a bit when the Bureau of Labor Statistics revises its data in early 2005. But there's little doubt that job growth has slowed significantly from the glory days of the '90s.

That sluggish performance is also starting to raise questions about the

economy's underlying strength. Tepid job growth weakens household incomes and makes the economy more vulnerable to negative shocks, such as more bad news out of Iraq. That's why some economists have started lowering their gross domestic product forecasts for the fourth quarter and beyond.

What's holding back job creation? Many believe the problem is short-term in nature, caused by such factors as this year's unusually active hurricane season,

political uncertainty, and the spike in prices (page 35). Others blame more persistent influences, such as high health care costs and intense global competition.

Yet the data clearly suggest that the job machine may have developed a long-term stutter for other reasons. The current shortfall in job growth, in fact, heaviest in a few surprising sectors, such as retailing, education, and health care, telecommunications is a big culprit as well. A comparison of how many jobs these sectors added over the past year with the average number they added annually during the 1990s indicates that these laggards, for the most part, are undergoing structural changes that make return of robust job growth unlikely anytime soon.

The hardest-hit has been retailing, squeezed by low-cost Wal-Mart Stores Inc. and high-productivity online retailers. Retail jobs rose by only 94,000 during the 12 months ended in September, far lower than the annual average gain of 210,000 jobs in the earlier decade. Next on the list is education, where the slowdown in growth of K-12 enrollment has dramatically reduced hiring. Other job laggards, such as telecom and health care,

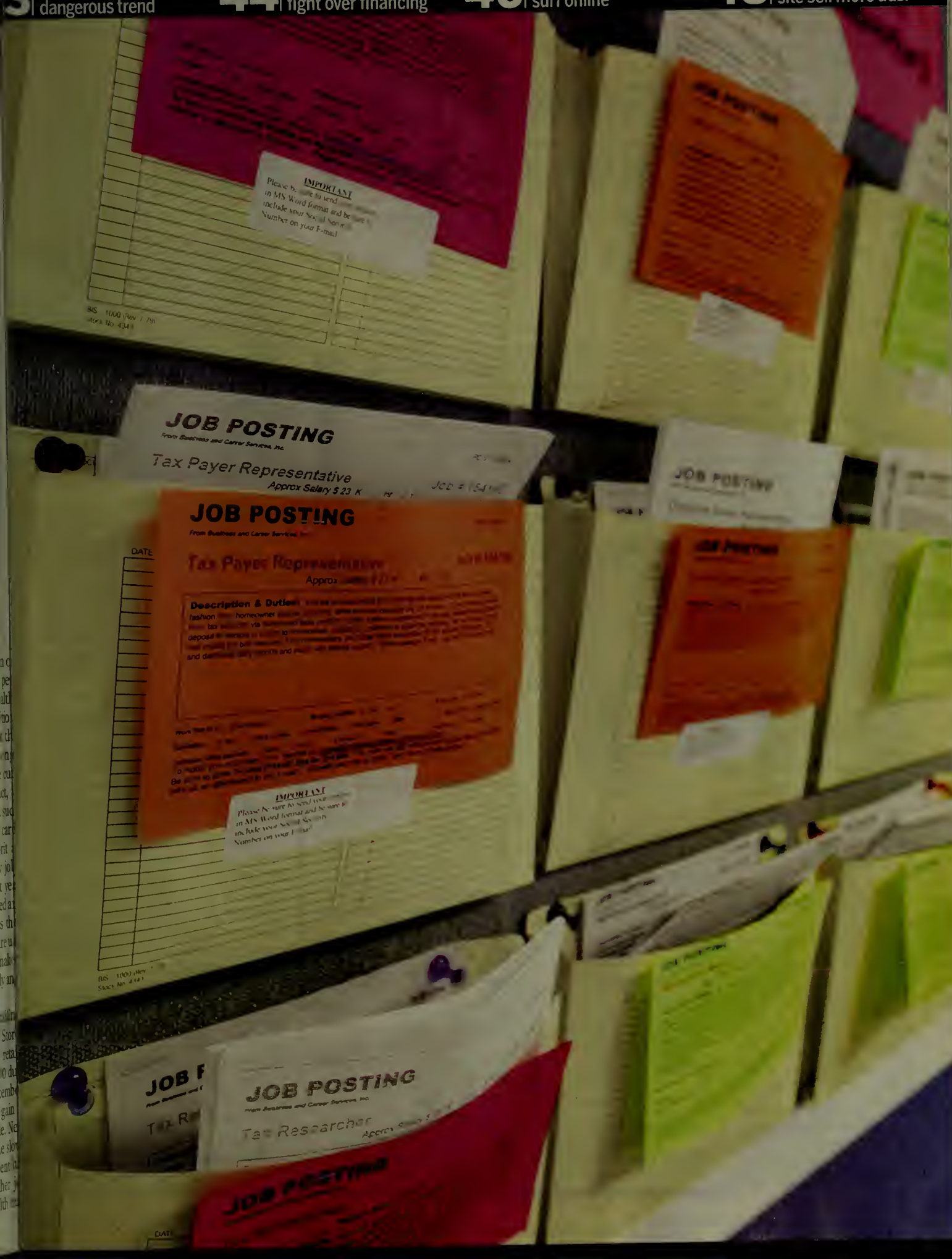
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face severe pressure to reduce costs. And the arts, entertainment, and recreation sector, which created 65,000 jobs per year in the 1990s, added only 10,000 over the past year. One explanation: upheaval brought on by new technologies in areas such as the music industry.

The story in manufacturing, especially recently, is a bit more complicated. Manufacturers were not contributors to the job boom of the 1990s, with factory employment falling by 400,000 annually, on average, over the decade, and continuing to plunge in 2001, 2002, and 2003. Thus, the 9,000-job increase in manufacturing over the past year, however small, marks somewhat of an improvement.

Overseas Shift

STILL, GAINS IN manufacturing employment should have been a lot bigger thanks to the recent jump in retailing productivity. How so? The logic is simple: Lower costs and higher productivity help retailers hold down prices. Lower prices, in turn, enable consumers either to buy more from that company or to spend elsewhere. That creates a greater demand for services and other manufactured goods.

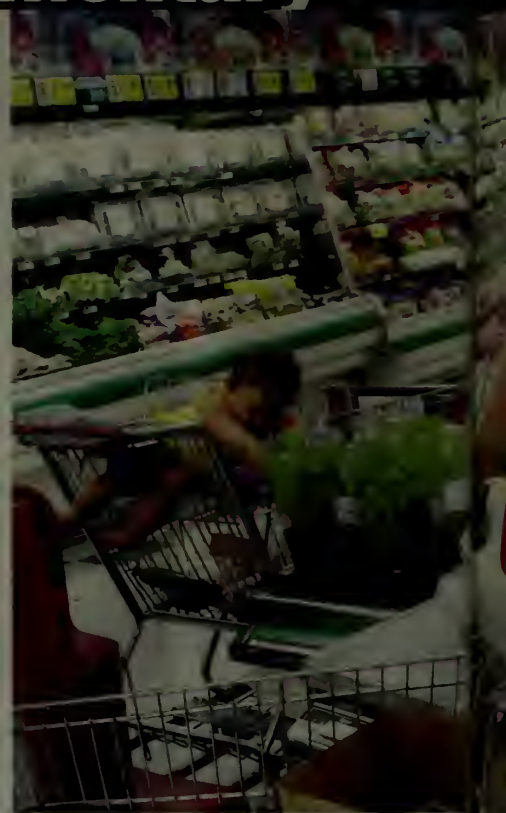
But while gains from higher retailing productivity are boosting demand for goods, the resulting factory jobs are showing up in other countries. Retail sales rose by a strong \$62 billion over the past year, measured in 2000 dollars. But guess what? Imports of consumer goods, motor vehicles, and foods and beverages rose by exactly that amount. So rather than creating 100,000 or more manufacturing jobs in the U.S., that \$62 billion in spending only hiked job growth elsewhere.

Given the continued pressures, it's unlikely that the forces holding down job growth are going to abate in the near term. The newfound productivity boom in retailing underscores the point. Until recently, much of retailing had been stuck in the productivity doldrums. From 1990-2002, output per hour rose by only 1.7%

per year in department stores and motor-vehicle dealers, and a meager 0.2% per year at food and beverage stores, including grocers. Together these industries account for over 40% of retailing employment.

Over the past year, though, a combination of job cuts and new technology, from improved inventory-management systems to wireless computers that allow shoppers to cut checkout time by scanning their own groceries, have led to much bigger productivity gains in these industries—4% or more, according to estimates by *BusinessWeek*. But these retailers will still have to hold down hiring if they hope to compete with Wal-Mart and an ever-more-efficient set of online rivals. Published data show that online retailers boosted productivity by 16% in 2003, while *BusinessWeek* estimates suggest that productivity growth accelerated yet a further 20% by the middle of 2004. Amazon.com Inc., for example, boosted its workforce by 8% in the year ended in June, 2004, but its sales were up 34% compared with the previous year. That translates into a 24% gain in sales per worker and explains why online retailers added only 12,000 in the past year. The bottom line: Retailing isn't likely to soon regain its prominence as a job creator.

TECH HELPER
Productivity gains in retailing hold down hiring



The same is true in education, where slowing job growth is driven mainly by demographics. During the '90s, elementary and secondary enrollment rose by an average of almost 700,000 students per year, generating huge demand for new teachers. Today, the Education Dept. estimates that the increase in the student population is much slower, with enrollment growing by only 160,000 in 2004.

An Eye on Telecom

PARTLY AS A RESULT, the education sector added only 135,000 jobs over the past year, compared with an annual average of 240,000 in the 1990s. The BLS recently reported that the number of people working in education, training, and library occupations hadn't risen at all over the past year despite gains in most other occupations. Since teaching and related professions almost all require a college degree, such stagnation in education-related jobs is also one factor in explaining why the college-educated job market continues to remain troubled. That's a critical difference between the 1990s and today.

Given these demographic changes, it's unlikely that a rebound in education hiring to the levels of the 1990s is on the horizon. The only thing that could change the equation would be enough additional government money to significantly lower teacher-student ratios in 12 schools or to significantly boost enrollments at the college level.

The long-term job situation is not

Where Are the Jobs?

In the 1990s the economy averaged 2.2 million new jobs a year. Now that number is just 1.7 million. But the shortfalls aren't where you might expect.

	JOB GROWTH ANNUAL AVERAGE 1990-2000	JOB GROWTH YEAR ENDED SEPT., 2004	SHORTFALL
	IN THOUSANDS		
Retail trade	210	94	-116
Education	240	134	-106
Telecommunications	28	-41	-69
Health care and social assistance	342	280	-62
Arts, entertainment, and recreation	65	10	-55
State and local government, except education	102	50	-52
Computer services	84	33	-51
Finance and insurance	70	26	-44
Business support services	28	-9	-37
Repair and maintenance	23	-5	-28

Data: Bureau of Labor Statistics

Data: Bureau of Labor Statistics



ECONOMICS

NOBEL WINNERS WITHOUT MUCH IMPACT

The work of Prescott and Kydland win praise for insight, but not practicality

IN ACADEMIC CIRCLES, IT'S CONSIDERED bad form to ask a macroeconomist to predict how fast the economy will grow next year. That's grubby work, best left to seat-of-the-pants practitioners. Then again, shouldn't economic theories from the ivory tower be judged by the accuracy of the real-world predictions they generate?

Apparently not, at least if you're sitting on the committee that awards the Nobel prize in economics. On Oct. 11, the award went to Edward C. Prescott, 63, of Arizona State University and the Federal Reserve Bank of Minneapolis, and Finn E. Kydland, 60, of the University of California at Santa Barbara and Carnegie-Mellon University. They won for two key papers: The first demonstrated that monetary policy works best when central bankers pursue consistent policies; the second tied the ups and downs of the business cycle to technological progress.

PARLOUS STATE

BUT WHILE economists generally laud Prescott and Kydland for the insight and originality of their work, its practical impact has been limited. That speaks volumes about the parlous state of macroeconomics today. Ken Matheny, a senior economist at leading forecaster Macroeconomic Advisers LLC in St. Louis, says that while he admires the Nobelists, "In a sense, their work has had very little impact on what we do."

Of the two papers, the first, a 1977 study of the problem of "time inconsistency," seems to have had the most influence. It said that policymakers lose cred-

ibility, and thus leverage over the economy, when policies are inconsistent over time. The Federal Reserve in the 1970s said it was committed to curbing inflation, for example, but it periodically lowered rates to ease joblessness, which stoked inflation. Eventually, people stopped trusting the Fed to keep prices in check, one factor that led to years of stagnant growth and high inflation.



FINN KYDLAND



EDWARD PRESCOTT

The **Ideas** That Won the Prize

WHY CONSISTENCY MATTERS Governments lose credibility—and their influence over the economy—when they abandon long-term commitments to solve short-term problems.

WHAT CAUSES THE BUSINESS CYCLE Growth spurts and recessions are largely unaffected by monetary policy or changes in demand. They're mostly the result of fluctuations in the growth rate of productivity.

Central bankers appear to have learned that lesson since. The 1977 paper made clear that they should not goose growth with low interest rates if doing so would call into question their commit-

oomy, however. Consider telecommunications, which was a moderate job creator in the 1990s, adding about 100,000 per year. Now, of course, the sector is in slash mode, cutting 40,000 jobs over the past year, with more to come. On Oct. 7, for example, AT&T announced plans to shrink its workforce by an additional 7,400 jobs on top of what it had already announced. But in the long run, telecom could again become a net generator of jobs as new services are developed and the need for workers to install and maintain broadband connections—more temperamental and finicky than ordinary phone lines—keeps growing. Both presidential candidates have voiced support for an expansion of broadband connections.

Then there's health care, which added 280,000 jobs in the past year. That's a big number, but not as many as the annual job gain of 340,000 in the 1990s, with much of the shortfall coming in nursing homes and home health care. However, here demographics are a plus. As the population ages, health-care employment will likely accelerate. The lesson here is that the days of prolific job creation are over, at least until another breakthrough innovation such as the Internet comes along. In the 1990s, the wind was at our backs, and jobs were easy to come by. Today job creation is much tougher for many reasons—and for now that's just a reality we have to live with. ■

ment to sound money. Some central banks, including those of Britain and New Zealand, have announced target rates for inflation; others, like the Fed, have earned the markets' trust without setting explicit targets.

CONTROVERSIAL

FISCAL POLICYMAKERS, though, haven't absorbed the lesson and probably never will. Lawmakers seem unable to commit themselves and their successors to restraints on spending—witness the failure of budget caps to control deficits.

More controversial, though, has been an idea that Prescott and the Norwegian-born Kydland came up with in 1982 that was later dubbed "real business cycle"

One theory doesn't quite match reality

theory. It was an alternative to Keynesian economics, which had difficulty explaining the sluggishness of the '70s and early '80s. As later developed by other economists, the theory held that the ups and downs of the business cycle were affected mainly by fluctuations in the rate of technological progress

and other supply shocks such as oil-price spikes, and much less by monetary policy or shifts in consumer demand.

While appealing in its novelty, the theory doesn't quite match reality. It predicts that a jump in the rate of technological progress would cause jumps in both output and number of hours worked. That was true in the '90s, but no longer. Now high productivity growth seems to be suppressing job growth. It's also hard to build a real-business-cycle model that produces usable forecasts. At forecaster Global Insight Inc. in Waltham, Mass., Chief Economist Nariman Behraves says "the data's just not there" to create a workable real-business-cycle model.

This is the first Nobel for macroeconomists after four straight years of awards to microeconomists and statistical experts. Other economists are split over whether it was a good choice, one symptom of the lack of direction in the field. "It's not clear that we understand that much more about macroeconomics than we did 30 years ago," says Paul Ormerod, a British economist and author of *The Death of Economics*. In an Oct. 12 press conference, Prescott said: "Economics has matured. It's become a hard science." If only that were true. ■

—By Peter Coy in New York

ENERGY

The Winter Oil Forecast Is Far from Cozy

Like most Americans, retiree Jerry Sugarman of Matunuck, R.I., has gotten used to paying higher prices at the pump to fill up his Toyota Sequoia sport-utility vehicle in recent months. But that didn't make it any easier for Sugarman to face yet another round of sticker shock: filling the heating-oil tanks at his three-bedroom house. At \$1.54 a gallon, the cost was more than 50% higher than he paid last year. Says Sugarman: "I don't like it, but I don't have any control."

The story is the same all around the country. From natural gas and propane to heating oil and gasoline, prices are on the rise. Even in regions where a milder winter is expected to ease demand, higher prices are expected to push up household fuel bills. The federal Energy Information Administration figures that the average household will spend from 15% to 28% more to heat its home this winter. A colder-than-expected season could further widen those increases.

It's not just near-record crude oil prices, now about \$53 a barrel, that are putting the squeeze on household energy bills. Tight inventories are also adding to the pressure on heating oil, used mostly in the Northeast. Senior analyst L. Bruce Lanni of A.G. Edwards & Sons Inc. figures that distillate inventories, which include heating oil and diesel fuel, are down 6% from year-ago levels and 3% below average. And the fourth quarter is typically a period in which inventories are drawn down, not built up, because of high demand and refinery maintenance. Lower-than-average supplies coupled with a cold

winter could lead to price spikes in the Northeast, warns analyst Dominick A. Chirichella of the Energy Management Institute of New York, a consulting company. His advice: "Buy some heavy sweaters."

Gasoline inventories are in healthier shape. But unless crude oil prices fall near \$40 a barrel, analysts believe consumers could see higher prices at the pump. Gasoline prices as of Oct. 11 averaged about \$1.99 a gallon nationwide, below their peak in May but up 8% from a month ago. "It's almost amazing that we still see

gas at under \$2 a gallon in a lot of areas," says Gene Edwards, senior vice-president at refining company Valero Energy Corp.

Natural gas users won't be spared this winter, either. The Energy Information Administration predicts that average residential natural gas prices will rise 11% over last winter and household spending 15% because of higher consumption. Worse yet, rising demand and tight supplies suggest that higher gas prices are here to stay. Mark G. Papa, chief executive of independent oil and gas producer EOG Resources Inc., estimates U.S. demand for natural gas will grow

by 1.7 billion cubic feet a day next year for electricity generation, residential heating, and other uses. At the same time, supplies will shrink. "We're not going to be able to drill our way out of this," says Papa.

Better grab that sweater. Consumers are about to get hit with some awfully big energy bills this winter—and perhaps beyond.

—By Wendy Zellner in Dallas, with William C. Symonds in Boston



CHICAGO BLUES An oil delivery

Heating Up

Estimated increase in household expenditures*

NATURAL GAS	HEATING OIL
+15.3	+28.4
Percent	Percent

*For Oct. 2004-Mar. 2005, compared with the same period a year earlier. Data: Energy Information Administration

BY MIKE FRANCE

One Man, One Vote, Two Lawyers

As more close races are decided in court, faith in the process may suffer

HISTORIANS WILL probably debate the consequences of the 2000 Presidential election forever. But one legacy of that contest is already apparent: Lawyers have become a far more important part of the campaign process. This year, both Democrats and Republicans have retained hundreds of attorneys across the country. They are already fighting

in swing states over the rules on voter registration, poll identification, and provisional voting—and will be ready to race into court on Nov. 2 should there be any electoral irregularities.

This year's legal brinksmanship is driven in large part by the closeness of the race and ambiguities in federal election reforms passed in the wake of the 2000 mess. But that doesn't necessarily mean that it's a one-time event. Sadly, there's reason to believe that a permanent change is instead taking place in American politics. Lawyers will no longer be merely marginal players who counsel candidates on arcane campaign finance laws, but key strategic advisers who try to change the rules of the electoral battlefield to favor their clients.

The inescapable truth is that candidates who are aggressively willing to litigate every phase of the voting process—from absentee balloting before election day to the recounts afterwards—can gain a clear edge over opponents. Political law experts interviewed by *BusinessWeek* estimated this advantage to be as high as one full percentage point. While that's not enough to lock up most races, it will tilt a lot more of them than you'd guess.

As a result, the legal genie has escaped the bottle. There will be much more pressure, in tight races, for politicians at all levels of government to exploit the tactical advantages that can be supplied by aggressive lawyers. In the wake of the Florida recount battle, "it is sort of accepted that people will bring a lawsuit after a close election," says Kenneth A. Gross, a political law partner at Skadden, Arps, Slate, Meagher & Flom LLP. "In

the past, it was sort of taboo, like you were a sore loser."

The lawyering of American elections could bring vast changes to the political process—just as the arrival of increased litigation permanently changed the health-care system and the workplace. Despite recent reforms, American elections still have an overall error rate of about 1% to 2%, according to Samuel Issacharoff, a specialist in campaign law at Columbia Law School. So if armies of attorneys start scrutinizing close races in search of problems, they'll find them.

That, in turn, means that lawyers will inevitably drive more races into the courts—undermining faith in the integrity of the electoral process. Voting results will be postponed and winners will increasingly be announced with the bang of a gavel. "It will say to the people who vote that the system works so poorly you can't trust it," says R. Doug Lewis, executive director of the Election Center, a Houston nonprofit that studies voting reforms and trains election officials. "At some point, they may start saying to themselves: 'Why are we participating?'"

Because lawyers are expensive, money likely will become more crucial than ever in politics. Both George W. Bush and John Kerry have already built multi-million dollar war chests to pay for recount battles. Third-party candidates and others who can't afford to field large teams of attorneys will be disadvantaged.

HIDDEN COST

Court battles could mean bigger election bills

Costs may also rise for thousands of counties across the country that administer the electoral process. When lawyers challenge their voting procedures, the

solution will often be to throw more money at the problem by buying new machinery or hiring additional staff. That will pull funds away from other priorities, such as building schools or buying police cars.

Of course, this is not all bad. Elections in this country have long been underfunded. If the arrival of more lawyers means more new voting machines, that will be an improvement. But partisan attorneys are not interested in improving elections—just in ensuring that their candidates win; as often as not, litigants will oppose reform. At the end of the day, the lawyers will probably just battle one another to a standstill, driving up costs and aggravation across the board while doing little to improve American democracy. ■

—With Lorraine Woellert in Washington



PLANEMAKERS

LOOK, UP IN THE SKY— IT'S A DOGFIGHT

Will the Boeing-Airbus battle over financing stall plans for the latest jets?

AFTER MONTHS OF veiled threats, the fighters finally came out of their corners. On Oct. 6, the U.S. and the European Union both complained to the World Trade Organization that the other has broken trade rules in subsidizing its aviation industry. Washington jabbed first, accusing EU governments of providing billions in unfair aid to help Airbus overtake Boeing Co. as the No. 1 commercial planemaker. Brussels slugged right back, countering that Boeing is set to rake in billions in unwarranted U.S. aid to develop its latest jet, the 7e7.

The showdown has the makings of a heckuva bout, with huge stakes for global trade, U.S.-Europe relations, and the companies themselves. Although a negotiated settlement is ultimately likely—neither side really wants to risk going all the way to the WTO court—both will clearly have to give up some government support to put the dispute behind them. And that could have a big impact on the financing and sales of the next generation of superefficient jets: the 7e7 and Airbus' yet-to-be-official A350.

Already airlines may be delaying orders for the new Boeing plane until they see how the fight plays out. "We've got time," says an official at one of Europe's biggest flag carriers. But Boeing clearly feels the price is worth paying: The U.S., in tandem with its WTO action, pulled out of a 1992 bilateral pact that has allowed Airbus to borrow up to 33% of the cost of

new aircraft development in risk-free government loans. Stopping those loans is Boeing's main goal. "You're delivering and selling more airplanes than Boeing," Boeing CEO Harry Stonecipher said of Airbus during a call with reporters on Oct. 11. "Why don't you go to the bank and borrow money?"

No question, without those loans, financing the A350 will get much tougher.

“This is ‘a massive campaign of untruths whose chief goal is to protect the enormous subsidies to [Boeing’s] 7e7.’”

—Noël Forgeard
Airbus Chief Executive



“You’re delivering and selling more airplanes than Boeing. Why don’t you go to the bank and borrow money?”

—Harry Stonecipher
Boeing Chief Executive

With its double-decker A380 set for launch in early 2006, Airbus probably could tap at least \$2 billion from its cash flow between 2006 and 2008 to develop the A350, say analysts. But that money would barely finance a modest revamp of the current A330, which almost certainly wouldn't match the 7e7's promised fuel savings. To do that, Airbus might have to spend more than \$6 billion.

Where would the extra money come from? Airbus would probably look for partnerships with foreign firms that can win state financial support. That's what Boeing is doing with the 7e7. By yearend Boeing is set to sign contracts with Mitsubishi Heavy Industries Ltd. and other Japanese companies that will build a third of the plane. The Japanese government is expected to lend the suppliers at least \$1.2 billion, covering two-thirds of their development costs. It will be tough for Airbus to line up similar pacts in Japan, since Boeing dominates the market. But Airbus is already looking elsewhere. On Oct. 9 the same day it closed a \$26 billion aircraft sale to two Chinese airlines, Airbus signed a \$100 million deal with state-owned China Aviation Industry Corp.

A HEAD START FOR BOEING?

EVEN IF AIRBUS secures financing, timing is a problem. Developing a whole new plane would take Airbus at least four years, meaning the A350 wouldn't get airborne before 2010, two years after the 7e7. That would give Boeing a head start as the



airline industry begins pulling out of its deep slump. "This plane is going to be successful on its merits," says Peter Gardner, vice-president of technical operations for Cathay Pacific Airways Ltd. "It's what the industry needs."

Yet the WTO skirmish could hurt Boeing's new plane, too. Airbus CEO Noël Forgeard has accused Boeing of "a massive campaign of untruths whose chief goal is to protect the enormous subsidies to the 7e7." Among other things, the EU is challenging a \$3.2 billion tax break that Washington state has promised Boeing and its suppliers. Stonecipher has hinted that Boeing might forgo some of the tax break if Airbus gives up the government loans. While Boeing says

losing all or part of the break would have minimal impact, some analysts believe it could hurt profits.

For now, this fight is still in the early rounds, and it's far from clear who will prevail. But one thing is certain: The aviation-subsidies game is about to get a whole lot more complicated. ■

—By Carol Matlack in Paris
with Stanley Holmes in Seattle

> With Sprint, Geek Squad at Best Buy is beautiful.

A collage-style advertisement for Sprint featuring Geek Squad members at Best Buy. The top left shows a close-up of a man holding a yellow Sprint phone. The top right shows a window view of the Geek Squad service area. The bottom shows three men running towards the camera, with a Best Buy store and Sprint cars in the background.



Geek Squad®, a 24-Hour Computer Support Task Force found at Best Buy, depends on Sprint to take care of business. Armed with Sprint PCS Ready LinkSM Phones, Agents can stay linked with walkie-talkie-style communication. And when they need more detailed technical information, Sprint PCS Connection CardsTM provide high-speed wireless access, linking them to their company intranet, which can provide the same data access they'd have in the office. Sprint technology helps Geek Squad expedite solutions, improve customer service and efficiently handle over a thousand customers a day. And a fast, connected Geek Squad is, in our opinion, beautiful. **With Sprint, business is beautiful.SM**

> Visit Sprint.com/beautiful for case studies or call 877-777-5568 >



THE INTERNET

ALL THE NEWS YOU CHOOSE—ON ONE PAGE

RSS, which delivers custom-tailored bulletins to users, may shake up e-media

SARAH HOUGHTON USED to get her online news the traditional way: by visiting 10 of her favorite sites several times a day. But since joining the free online service Bloglines a year ago, the San Rafael (Calif.) librarian surfs no more. Now the news comes to her. Using software known as RSS—for Really Simple Syndication—Bloglines pulls together regular updates from a variety of sites. Houghton can check them each time she logs on to the service. “RSS is the primary tool I use to get news,” says Houghton, 27. “It’s all delivered to me; I don’t have to go searching anymore.”

Houghton has plenty of company. Consumers, along with businesses such as Apple Computer, Netflix, and Yahoo! are jumping aboard the RSS bandwagon. The reason: While Web sites have long sent promotions and news alerts to their visitors, RSS takes things to a whole new level by giving consumers much more control over what they see and how often they see it. “We believe the world is moving from mass media to ‘my media,’” says Daniel L. Rosensweig, chief operating officer at Yahoo Inc., which last month be-

gan testing feeds to the 20 million subscribers of its My Yahoo service.

If you aren’t familiar with RSS, perhaps you remember push technology, the late great killer app of the ’90s. Like RSS, push let people get news updates delivered to their computers. But it used so much bandwidth it clogged corporate networks, and it never caught on because consumers had little control over what they got.

RSS—designed by independent engineers and helped along by Netscape Communications Corp.—was built to be simpler. Consumers can use it by downloading a news reader, such as FeedDemon or NewsGator, that pulls together updates in one place on a PC, or by signing up for an online service such as My Yahoo or Bloglines, which aggregate updates on a personalized Web page.

RSS began catching on a couple of years back, when Web logs, or blogs,

started using it to let readers know they had posted something new. Soon traditional publishers dove in. During the past year, *The Wall Street Journal*, National Public Radio, and Reuters Group have added RSS feeds. Companies have only recently begun to experiment with putting ads on the services. For now they’re attempting to lure readers to stories posted on the main site, where their ads are. To do that, big media outfits are putting only the barest information—a headline or synopsis—on their RSS feeds. To read the whole story, you click on a link and jump to the ad-rich main site.

TOPPLING THE GIANTS?

WHILE RSS COULD HELP media titans sell more ads and keep users loyal, the technology could undermine the giants too. RSS levels the playing field between upstarts and the established media, since news readers don’t distinguish between blogs like Gizmodo, which covers consumer electronics, and publications such as *PC Magazine*. Some believe RSS could make online media even more fragmented than it is today, setting off a struggle for ad revenue. The biggies claim their brands will insulate them against upstarts. Says Catherine Levene, vice-president for product, business development, and strategy at New York Times Digital: “We think people will still come to [our site] for our editorial judgment.”

So far most online merchants haven’t embraced RSS. But the potential exists for Web stores to alert customers that they now have that snazzy blouse in aqua. Web-savvy outfits, including Amazon.com, Apple’s iTunes Music Store, and the Netflix DVD-rental service al-

ready use RSS to alert customers to new music or movies. Analysts expect travel, apparel, and financial sites to start testing the technology early next year.

So is surfing dead? Not quite. While RSS is good for getting updates, it can’t do research or comparison shopping. And although it’s simpler to use than earlier technology, it remains

more complicated than a browser. But RSS will probably evolve into one more way of bringing buyers and sellers together on the Web. ■

—By Heather Green in New York

WHY SURF?

Technology called Really Simple Syndication (RSS) is changing the way people use the Web

STRAIGHT TO YOUR SCREEN Consumers receive regular updates from favorite Web sites, eliminating the need to monitor those sites directly

TARGETING EYEBALLS News outfits and blogs send alerts, while the likes of Apple and Netflix keep customers abreast of new releases

When you want to express your devotion to The Dow, nothing says it like Diamonds (DIA). Exchange traded funds (ETFs) that give you 30 blue chips, the entire Dow Jones Industrial Average, in every single share. You can buy and sell Diamonds all day long, just like a stock. They're tax efficient, and have low management fees, too*. Ask your advisor for details. Or forever hold your peace. www.DowDiamonds.com. Ticker symbol Amex:DIA. The 30 blue-chip companies of The Dow in every share.

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THE INTERNET

YOU'VE GOT MAIL— BUT NOT ENOUGH ADS

AOL is counting on a redesigned Web site to help propel it back to the top tier

IN THE PAST TWO YEARS, ADVERTISING on the Internet has taken off. But one online giant has been conspicuously missing from the party. With 23.4 million U.S. subscribers, America Online Inc. should have raked in fistfuls of ad dollars along with Yahoo!, MSN, and Google. After all, the leading subscription service beats its top rivals in time spent online per visitor—401 minutes a month. Yet in ad sales, AOL trails the others, booking just \$221 million in the second quarter, vs. \$467 million for industry leader Yahoo! Inc. “For so long, the Big Three were AOL, MSN, and Yahoo,” says Jeff Lanctot, vice-president at Seattle’s Avenue A/Razorfish, a leading online-ad agency. “Increasingly, the Big Three are Yahoo, MSN, and Google.”

Can AOL muscle its way back into the top tier? It sure is trying. On Oct. 14 the online giant was expected to launch a redesign of its aol.com site. Used mainly by subscribers to check e-mail away from home, it will come loaded with much more content and services, including a news ticker and beefed-up sports and music. The idea: invite greater use by members and, in turn, attract more advertisers. What’s more, AOL execs

say, they will soon throw open the site to the nonmembers to gin up even more ad sales. Says Mike Kelly, president of AOL Media Networks: “Our goal is to get a fair share of the ad market.”

FREE IS WHERE THE ADS ARE

THAT’S A MUST, considering AOL’s bread and butter subscription business is stagnating. But CEO Jonathan F. Miller’s embrace of a free site on the Web may be a tacit concession that a business model based on subscriptions is fast becoming obsolete in the broadband era, when Web surfers can navigate easily to any destination on the Web. It’s a move others have already made. Over the past three years, for instance, MSN scaled back its Internet access business sharply to focus on its free site. Now the MSN site has a panoply of free services, from Microsoft Corp.’s Encarta encyclopedia to phone directories to driving tips. With nearly 100 million visitors flocking to the site every month, MSN has also become a magnet for advertisers.

Another key reason advertisers love MSN,

Google, and Yahoo is their prominent search features. While AOL partners with Google in search, it must share all search-related ad dollars with the search giant.

Still, by fishing for ad dollars on a non-subscription site, AOL must strike a careful balance. Miller must offer just enough content and services from his flagship service on the open Internet to lure fresh customers and ads but not so much that loyal members realize they’d be better off canceling their monthly subscriptions, which range from \$14.95 to \$24.95, in favor of using the free site. Given AOL’s much larger subscription base, that’s a much tougher task than MSN faced.

Miller, who declined to comment for this story, has little choice but to go all out to nab ads. As subscribers defect to broadband and discount dial-up brands, the total number of subscribers has fallen 12%, from a high of 26.7 million in 2002. Meantime, online advertising and commerce, just 13% of total sales now, is the surest road to the double-digit growth that parent company Time Warner Inc. demands from AOL’s bottom line. Industrywide, online-ad revenues jumped from \$5.8 billion in 2002 to an estimated \$8.4 billion this year, according to Jupiter Research.

One problem: AOL had to dust itself off from an accounting scandal that broke in ’02 and a pending Securities & Exchange Commission investigation. While Miller has been rebuilding a decimated ad staff, MSN, Yahoo, and Google have been thriving, with crack ad teams who push new ways to promote ads on their nonsubscription sites. Indeed, on Oct. 12, Yahoo reported a 91% jump in third-quarter profits, to \$124 million, largely on higher ad sales.

AOL is making some gains. In June, AOL bought the Advertising.com ad network for \$435 million to help boost its ad business. The move seems to be paying off. Its second-quarter ad sales were up 23% from a year ago. But from here on out, the action will likely be on the free Web sites. Now the trick is to woo advertisers without losing subscribers. That won’t be easy, but it’s a tightrope AOL has no choice but to walk. ■

—By Catherine Yang in Washington
with Jay Greene in Seattle

CEO MILLER
Striking a balance of paid and free content

AOL:
Ahead in
Eyeballs,
Behind in
Revenues

MONTHLY MINUTES ONLINE, PER VISITOR, SEPTEMBER, 2004

AOL	Yahoo!	MSN	Google
401	279	151	29

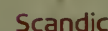
ONLINE-AD REVENUES, QUARTER ENDED JUNE 2004 (IN MILLIONS)

Yahoo!	MSN	Google	AOL
\$467	\$437	\$328	\$221

Data: eMarketer Media Metrix; company reports



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COMMENTARY

BY JOHN CAREY

A Booster Shot for Vaccines

New technology could speed development and keep the medicine chest stocked

THE U.S. IS NOW lurching into the flu season with only about half the expected supply of 100 million doses of vaccine on hand. How could a nation capable of putting half a billion transistors on a chip, and a man on the moon, stumble so badly in making a decades-old vaccine?

The answer is simple. The world hasn't made vaccines a high enough priority.

Annual global sales for all vaccines are a mere \$8 billion, less than that of one single blockbuster drug, Lipitor. Another big problem: Making vaccines is complex work, with lots of investment in manufacturing needed, along with special expertise. Yet weak pricing has left profitability low. That combination has scared many companies away from the market.

Yet the benefits of vaccines are clear: Immunizations save the U.S. alone roughly \$40 billion each year in medical costs and lost productivity. Better and more available vaccines would bring dramatic benefits worldwide. Says Victor Zonana, co-founder of Global Health Strategies: "It's scandalous how society simply does not put a high enough value on vaccines."

The good news is that the seeds of the solution are already being sown—though more government support would help. "All the forces are at work to correct this," says industry consultant David L. Webster. Demand for vaccines, like prices, has been rising and the science is advancing. Companies are responding by developing a host of new vaccines and new manufacturing methods. The changing economics prompted MedImmune Inc. to jump in with a new nasally administered flu vaccine last year. On Oct. 14, scientists reported promising results with an experimental GlaxoSmith-Kline PLC malaria vaccine. And new techniques could lower the risk of a global flu pandemic.

The current shortage, resulting from British regulators shutting down Chiron Corp.'s flu vaccine

plant in Liverpool on Oct. 5, is just the latest example of the larger problem. Six years ago, the average price per dose of flu vaccine was about \$1.60. Total annual sales in the U.S. were about \$120 million, split among four suppliers. Small wonder that two dropped out of the U.S. market, leaving just Chiron and Aventis Pasteur Inc. "The big problem has been the price. It's been very low for years," says Dr. R. Gordon Douglas Jr., global health and vaccine consultant.

That's why flu vaccines are still made by a half-century-old method using millions of sterile fertilized chicken eggs. "The technology is cumbersome and not easy to scale up," says Piers C. Whitehead, vice-president of VaxGen Inc., a vaccine startup. Bacteria in one egg can contaminate an entire batch. Plus, not all viral strains grow in eggs. The strain responsible for most flu illness last year didn't, so the vaccine wasn't fully effective. And a deadly avian strain capable of jumping to humans—prospect many public health officials fear—would be lethal to eggs, making it impossible to produce a vaccine.

COLORADO A
"shots for tots"
program in
February



There's a better way: growing the virus in cells. A single room-sized vat could quickly make enough virus for 10 million doses of vaccine, enough to cope with shortages or the sudden emergence of a deadly new virus. A number of companies, including Chiron, Netherlands-based Crucell, and Canada's ID Biomedical Corp., are developing the technology, spurred by growing demand. The average U.S. price has jumped to more than \$8 per dose, and the global market is now about \$1.5 billion. That's expected to grow to \$3 billion per year by 2008. Says Dr. Ronald Brus, chief executive of Crucell, which is working with Aventis Pasteur: "That means the old-fashioned flu vaccine becomes a blockbuster."

Still, the Invisible Hand of the marketplace could use a little help in the form of boosted government research funding. Switching to new manufacturing technology isn't just a matter of modernizing plants. Companies also have to prove that a vaccine produced in cell culture is safe, and do clinical trials to show that it works. It will take several years to do all this, but the result will be a steady supply of reliable vaccines—and a much healthier vaccine industry. ■

**Novel types
of vaccines
may one day
become
blockbusters**

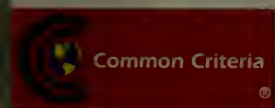


*Trends in Proprietary Information Loss Survey (ASIS 2002). ©2004 Sharp Electronics Corporation

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EDITED BY MONICA GAGNIER

HEADLINER

JIM DONALD



BARISTA NUMERO UNO

A former Wal-Mart Stores exec is taking the helm of Starbucks, as the Seattle company continues to expand beyond java. Jim Donald, 50, currently president of Starbucks North America, is set to succeed CEO Orin Smith, 62, who will retire in the spring. Starbucks hired Donald two years ago and has been grooming him for the top spot. He previously was CEO of Pathmark Stores and helped develop Wal-Mart's supercenter concept.

Smith presided over Starbucks throughout a time of bountiful growth. During his tenure, the number of Starbucks stores rose to more than 8,500, from 2,498.

Donald's job won't be so easy to pull off. He will take over at a moment when coffee prices are rising. So are health-care costs for Starbucks employees, who enjoy an attractive benefits package. To avoid a crimp on profits, Donald will have to come up with new ways to increase revenue beyond coffee (page 13) and keep costs in check. For now, though, the cup looks more full than empty.

—Stanley Holmes

FASB CALLS A TIME-OUT

Corporate America is getting a breather. After months of debate, the **Financial Accounting Standards Board** on Oct. 13 agreed to delay the mandatory expensing of stock options for six months, until mid-2005. The reason: to give companies inundated with legal and regulatory shifts a chance to catch their breath. But the delay may give opponents of the measure more time to lobby for a change that would reduce the impact on profits or even an elimination of the expensing rule altogether. Despite growing political pressure, FASB remains adamantly opposed to both options. On Oct. 13, it rejected an alternative method for valuing options that would cut the cost by 80%; it approved the final rule by a 5-2 vote.

DREAMWORKS DREAMS BIG



With a new hit on its hands, the computer-generated *Shrek Tale*, **DreamWorks** is pushing ahead with an initial public offering that could raise up to \$725 million. The animated studio, which had lost \$183 million over the prior two years, had profits of \$66.5 million for the first six months of this year, thanks to its summer hit *Shrek 2*. The

big winner: billionaire Paul Allen, who will sell 6% of his 64% stake in DreamWorks Animation's A shares for an estimated \$58 million. The company will be controlled by co-founders Jeffrey Katzenberg and David Geffen through super-voting B shares. Steven Spielberg, the third co-founder, chose not to be on the board to avoid making public his pay as a film director. He put a stake worth up to \$170 million into a trust for his children.

LOVE THAT IPOD

Unlike the chief executives of many PC makers, Steve Jobs isn't singing the blues. Riding high on sales of its popular iPod music player, Jobs' **Apple Computer** on Oct. 13 said its fiscal fourth-quarter profits more than doubled, to \$106 million, on a 37% jump in sales, to \$1.72 billion. While sales of its Macintosh PCs rose just 6% from a year ago, Apple sold more than 2 million iPods, up 500% from a year ago. Apple also boosted earnings estimates for the current quarter, sending its stock up in after-hours trading.

THE THORN IN INTEL'S SIDE

The pitched battle between **Intel** and archrival **Advanced Micro Devices** shows no signs of letting up. Intel on Oct. 12 reported a 15% gain in third-quarter earnings, lower than normal for the period, and predicted fourth-quarter results would be no different. The chipmaker blamed excess inventories at PC makers. But analysts point to AMD's growing strength in the microprocessor business (BW—Sept. 30). A week earlier, it reported its third-

quarter profit of \$43.8 billion came largely on the strength in microprocessor shipments and a spike in prices. AMD plans to increase the pressure: On Oct. 13, **Hewlett-Packard** said it was adding AMD chips to its Media Center PC lineup, and *BusinessWeek* has learned that **Gateway** also is considering adopting the AMD chips for some PCs and notebooks.

ET CETERA...

- The **SEC** proposed new rules to curb IPO abuses.
- Dutch grocer **Royal Ahold** has agreed to settle U.S. securities fraud charges related to inflating profits.
- **Johnson & Johnson** reported a 13% gain in third-quarter net income.

CLOSING BELL

Big Mac is back. **McDonald's** worldwide same-store sales rose 5.8% in the third quarter, even faster than last year's 3.9%. As a result, quarterly earnings will be 25% higher than expected. Wall Street ate up the news, sending shares up 5%, to \$28.86, on Oct. 13.



"...beautifully balanced..." Anthony Dias Blue, Bon Appetit, July 2004

"...a masterful move by Absolut..." F. Paul Pacult's Spirit Journal, March 2004: 4/5 stars — Highly recommended

"...a hauntingly delicious finish." Robb Report, June 2004

BALANCE FOUND: cocktail glasses

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EDITED BY LEE WALCZAK

All That Lard Could Clog Tax Reform

FOR FOUR YEARS, American business snapped to attention and saluted as President George W. Bush persuaded Congress to enact three big tax cuts aimed largely at slashing rates for individuals. True, lower top brackets helped CEOs personally, as did firms in the capital-gains levy. But as each Tax-Cut Express

rolled out of Union Station, business lobbyists were left behind.

No longer. On Oct. 11, Congress loaded a corporate gravy train with a \$137 billion bill bursting with business tax breaks. Obviously, it was designed as a replacement for a \$5 billion-a-year subsidy for U.S. exporters, a provision the World Trade Organization has ruled illegal. Instead, it became a vehicle for years of pent-up business demand for tax breaks, many of them not even remotely related to the original intention—helping out U.S. manufacturing. In the frenzy, railroads, barge operators, makers of fishing tackle boxes, NASCAR track owners, even foreign gamblers who hit it big at U.S. dog tracks—all cashed in. Says one Senate tax aide: “I couldn’t want to be the lobbyist who failed to get something in this bill.”

But take a good look at this year’s 633-page tax bill, and you may see a relic in the making. You may also see trouble ahead for any effort at tax reform.

The future for such traditional porkathons as the instantly named American Jobs Creation Act of 2004 is increasingly cloudy. A President John Kerry, who has vowed to take up Arizona Senator John McCain’s call for a blue-ribbon commission targeting corporate welfare, would likely go after many industry-specific breaks as he marches for tax revenue.

And even if George W. Bush is reelected, there could be lean years in Gucci Gulch before another round of business tax reductions comes along. Faced with a \$415 billion deficit and obliged to make good on a vow to cut the red ink in half, Bush will be

hard-pressed to cut corporate taxes anew.

Indeed, the real battle in a second Bush term may be over tax reform. If the President is intent on restructuring the revenue code, he will have to do so in a way that does not increase the deficit, economists say. That means a bill that closes egregious loopholes while it reduces tax rates on individuals. “From now on,” says a top business lobbyist, “the battle will be about keeping what you’ve got.”

Quixotic Mission?

SOME REFORMERS are upbeat. Says Chris Edwards, director of tax policy studies at the libertarian Cato Institute: “If Bush really gets behind reform, it has a chance.”



HANDS OFF
The Bush White House let Congress run wild

But other longtime reformers are glum, insisting that the business feeding frenzy shows that trying to halt the drive for loopholes is quixotic. The 2004 bill “demonstrates that there is no appetite for fundamental reform,” says John Endean, president of the American Business Conference, which represents mid-sized companies.

The hallmarks of tax reform are simplicity, fewer loopholes, and lower rates. But the corporate bill muddies the tax code with scores of complex new breaks. And while it does cut rates for manufacturers, it does so modestly and slowly. The top bracket would be pared gradually from 35% to 32%, but it would take until 2010—a tax code eternity.

With the election just days away, the White House let Congress run hog-wild. That decision could come back to haunt Bush if he ever mounts a serious drive to clean up tax laws. ■

—By Howard Gleckman

CAPITAL WRAPUP

EXECUTIVE COMP: ON A SHORTER LEASH

THE TAX BILL Congress passed on Oct. 11 might be a giant Christmas stocking for U.S. corporations, but it tightens the compensation rules for executives who run them. Honchos with deferred-compensation plans will face new measures designed to halt the sort of abuses seen when Enron Corp. was collapsing and top brass pulled out deferred-compensation money before it went bankrupt.

Execs who elect in advance to take their plan distribution when they leave a company will have to wait an extra six months if they’re a key employee (an officer or anyone earning over \$130,000). Also, says tax attorney Bruce J. Shnider of the Minneapolis firm Dorsey & Whitney, provisions allowing execs to withdraw money anytime if they accept, say, a 10% penalty will be banned.

Gone, too, will be plans that automatically pay out if a company’s credit rating slips below a certain level, Shnider says. Also, the bill outlaws foreign trusts that make it harder for creditors to get at the otherwise vulnerable deferred comp. (An exec due such money is treated as an unsecured creditor in a bankruptcy.)

The new rule also sets how far in advance an exec must decide how much to defer, under what circumstances distributions can be taken, and how they will be paid, says compensation consultant Paula Todd of Towers Perrin. Those who do not comply will be subject not just to interest but also to a 20% penalty, adds Shnider.

Still unclear is the impact on some types of equity compensation such as discounted stock options, stock appreciation rights, and restricted stock units.

—By Carol Marie Cropper

STRATEGIST

So far, Desmarest's moves have paid off handsomely



FRANCE

TOTAL TRIES HARDER

The hard-charging French oil giant may be the most profitable in the industry. Can it battle the behemoths?

AN HOUR'S FLIGHT FROM Aberdeen, the Scottish oil city, a boxy maze of yellow steel rises from the blue waters of the North Sea. It looks small from the air, but by any measure, Total's Elgin platform is a massive structure, weighing 43,000 tons and extending 90 meters below the waves and almost as high. Essentially, it's a mini oil refinery built to house nearly

100 workers and process the hefty 250,000 barrels of oil and gas a day that roar up from wells deep in the seabed—some of them several kilometers away.

Indoors behind the blast walls there is a noticeable *esprit de corps*. Scottish engineers natter away with their Gallic counterparts in fluent French. The talk is not all chitchat. Elgin began production only three years ago, and Total still hasn't figured out all the answers to a challenging environment. Extremely high reservoir

pressures and temperatures close 200C put "enormous amounts of stress" on the hardware, says David Atkin, the offshore installation manager.

CRUISE CONTROL

THE ELGIN CREW is coping with everything from valve failures to excessive vibration to potentially dangerous salt corrosion, yet they are still pushing the platform's capacity limits. Atkin says the hard-charging style is what separates the

Paris company from rivals content to operate on cruise control. "We try to experiment, even if it doesn't work," he says over a lunch of sausage and salad in the crew's mess.

That willingness to keep trying has paid off handsomely. A decade ago, Total was a relatively small outfit, pumping a puny 634,000 bbl. per day. Now the former also-ran ranks as one of four or five elite global majors, producing an average of 2.6 million bbl. of oil equivalent a day, roughly on a par with ChevronTexaco Corp. Total's profit growth has also been staggering—probably the best in the business—and its return on capital far exceeds the industry norm. "We are now making in a fortnight what we made in one year" a decade ago, says Chief Executive Officer Thierry Desmarest in a recent interview in his spacious but austere Paris office. Deutsche Bank forecasts that net income before exceptionals will be up 16% this year, to \$9.8 billion. Revenues are likely to be close to \$140 billion.

Total's rise to the ranks of the oil majors has had its controversial moments. Elf Aquitaine, which Desmarest acquired in 1999 for \$54 billion after a bitter fight, was a state-controlled entity embroiled in corruption scandals that took years to untangle. And Total employees still get targeted by authorities. In mid-September, French police raided Total's headquarters at La Défense in Paris as part of an investigation into questionable payments in deals with Iraq and Russia between 1996 and 2001. Investigating magistrate Philippe Courroye has filed charges against three current and former Total executives for complicity in the misuse of corporate funds, says his spokeswoman. While admitting that current and former staff have been questioned in connection with a money-laundering investigation, Total says the inquiry does not directly target the company.

The probe has not had a noticeable impact on Total stock. Investors are betting that the methodical Desmarest will continue his winning streak. Both colleagues and rivals say he is a shrewd appraiser of risk who asks all the right questions about the big projects that are the lifeblood of oil majors. Investors also applaud Desmarest's preference for self-generated growth rather than large mergers at a time of sky-high oil prices.

To take Total to another level of per-

"We don't think we have any problem of size," says Desmarest

formance, Desmarest is applying equal doses of caution and boldness. In Russia's oil patch, for example, Total's name has been linked with Sibneft, one of the oligarch-controlled giants. Instead, Total pulled a big surprise on Sept. 22 by reaching a tentative agreement to buy just over a 25% share in a relatively new gas producer, Novatek, which is owned by independent businesspeople. While high, the \$1 billion price tag is not a balance-sheet buster and fits with Desmarest's strategy of keeping a low profile in a high-risk region.

At the same time, Desmarest is making a bold move to boost Total's presence in the OPEC countries. Trying to overcome traditional OPEC suspicion of foreign investment, Total is telling the OPEC bosses that it is willing to operate in a way that creates jobs and respects local political and societal views. Desmarest has ideas, including "self-adjusting contracts" with companies like Total that would give the Middle Eastern states plenty of profit if prices remain high. He's telling the OPEC countries that however attractive today's prices may seem, a long-term oil crisis is not in their interests, and that OPEC members would be better off developing their fields in cooperation with the majors because it would assure long-term markets for their oil and gas.

Desmarest has shown guts more than once, striking deals with Iran and Libya in the mid-1990s despite the risk of U.S. displeasure. And Total has consistently added more reserves than it has depleted in recent years, unlike, say, Royal Dutch/Shell Group, which has been in deficit. Total, rivals say, probably has the youngest portfolio of properties and so the least worries about production levels crashing in the medium term. Fewer than 1 million bbl. per day of its output comes from mature regions such as the North Sea and the U.S.

OFFSHORE
Reserves are rising fast



A Total Winner

The French oil company outperforms the industry on a number of key benchmarks

TOTAL	INDUSTRY
RESERVE REPLACEMENT RATIO, INCLUDING ACQUISITIONS (1990-2003 AVERAGE)	
193%	147%*
RETURN ON CAPITAL EMPLOYED (2003)	
19.1%	15.0%**
FINDING AND DEVELOPMENT COSTS PER BARREL OF OIL EQUIVALENT (2003)	
\$4.48	\$8.17**
FULL CASH COSTS OF PRODUCTION, PER BARREL OF OIL EQUIVALENT, INCLUDING TAXES AND CAPITAL EXPENDITURES (2003)	
\$13.91	\$17.50**

*Western Average **Majors Average
Data: Deutsche Bank

BACK INTO IRAQ?

DESMAREST SAYS TOTAL'S strong position means he doesn't need another big merger. "We don't think we have any problem of size," he says. Well, not quite. Lacking the scale of ExxonMobil, BP, and Shell, whose output is in the range of 4 million bbl. per day, Total tends to get a lower price-earnings ratio from the market. One move that would greatly expand output would be into Iraq, where during the Saddam Hussein years, Total all but signed deals to develop two enormous fields. If they came to fruition, these projects would add enormously to the company's production base at a low cost per barrel. Rivals, however, say the Iraqi government will be reluctant to deal with Total, given its ties to the old regime and French opposition to the 2003 invasion.

Yet Total keeps trying. The company is said to have approached U.S. companies, including Exxon Mobil Corp., offering to marry its extensive knowledge of Iraq with their political clout. Neither company will comment, but it fits Desmarest's philosophy: Never give up—but do what it takes to improve your odds. For Total, the odds look pretty good. ■

—By Stanley Reed in Aberdeen

SOUTH KOREA

SAMSUNG INSIDE?

Look out, Intel. The Korean giant wants to become the No. 1 chipmaker

JUST A FEW YEARS AGO, Samsung Electronics had an inflexible rule regarding Sony and Intel, the two companies it saw as its chief role models and rivals: Never compare the companies' performance to Samsung's in public. But the prohibition on mentioning Sony Corp. fell two years ago as Samsung's market capitalization surged past that of the Japanese giant's.

Now, the Intel Corp. ban is starting to fall as well. On Sept. 20, Hwang Chang Gyu, president of Samsung Electronics Co.'s semiconductor business, strode into the ballroom of Seoul's posh Shilla hotel and boasted about Samsung's 80% revenue growth in semiconductors in the first half of 2004—noting that the figure was nearly four times Intel's growth. "Samsung's gap with Intel is bound to narrow," Hwang told the crowd of journalists and industry bigwigs. His ultimate goal, he said, is to become the world's biggest chipmaker.

Can Samsung really shove Intel from its perch at the top of the industry—a perch built on Intel's dominance of the market for PC microprocessors? The consensus among analysts is not any time soon. But while Samsung's semiconductor revenues today are just half that of Intel's, the Korean company is making headway in some key areas: flash memory, plus processors for mobile gadgets such as cell phones, digital cameras, and MP3 players. If the balance of power shifts

away from the PC and toward mobile gizmos, Samsung will make gains. The Korean company has already stormed past rivals such as STMicroelectronics and Toshiba Corp. to become the No. 2 global player, thanks mainly to its surging business in memory chips. In the first half of this year, Samsung sold \$7.4 billion worth of chips, giving it a market share of 7.3%. That's still well behind Intel's 14.7%. But in flash memory—used to store data such as photos in cameras and songs on mobile music players—Samsung overtook Intel last year, with 21% of the market, vs. Intel's 15%.

That advantage, Hwang argues, will only grow as mobile products fuel the industry's growth. Although Samsung has no interest in PC microprocessors, the two will butt heads as Intel tries to boost its share of mobile markets. Samsung also aims to gain more than 20% of the market for five key varieties of logic semiconductors, including image sensors in cameras, display driver chips that tell digital screens what to show, and processors that power all kinds of mobile gadgets.

Because Samsung already makes logic chips for many of its own devices, its execs say it's relatively simple to start churning them out for other companies. Already, Samsung is the top maker of LCD driver chips, selling \$902 million worth last year, giving it 19% of the market. Its target now is to grab a big share of the market for display driver chips for plasma screens, and



CHIP BOSS HWANG
He has plenty to boast about

projection TVs. Among its current customers: Sony, Nokia, and Motorola.

MOBILE RISKS

GOOD PLAN, SOME say, but Samsung's ambitions are grandiose. Sure, the company is the biggest memory-chip maker, but it "has yet to prove itself in the non-memory sphere," says Merrill Lynch & Co. analyst Simon Woo. Intel is not commenting, but sources close to the company say one big potential flaw is Samsung's role as both competitor and supplier in mobile devices: "They end up competing with their customers, and that's a disaster," says one industry insider.

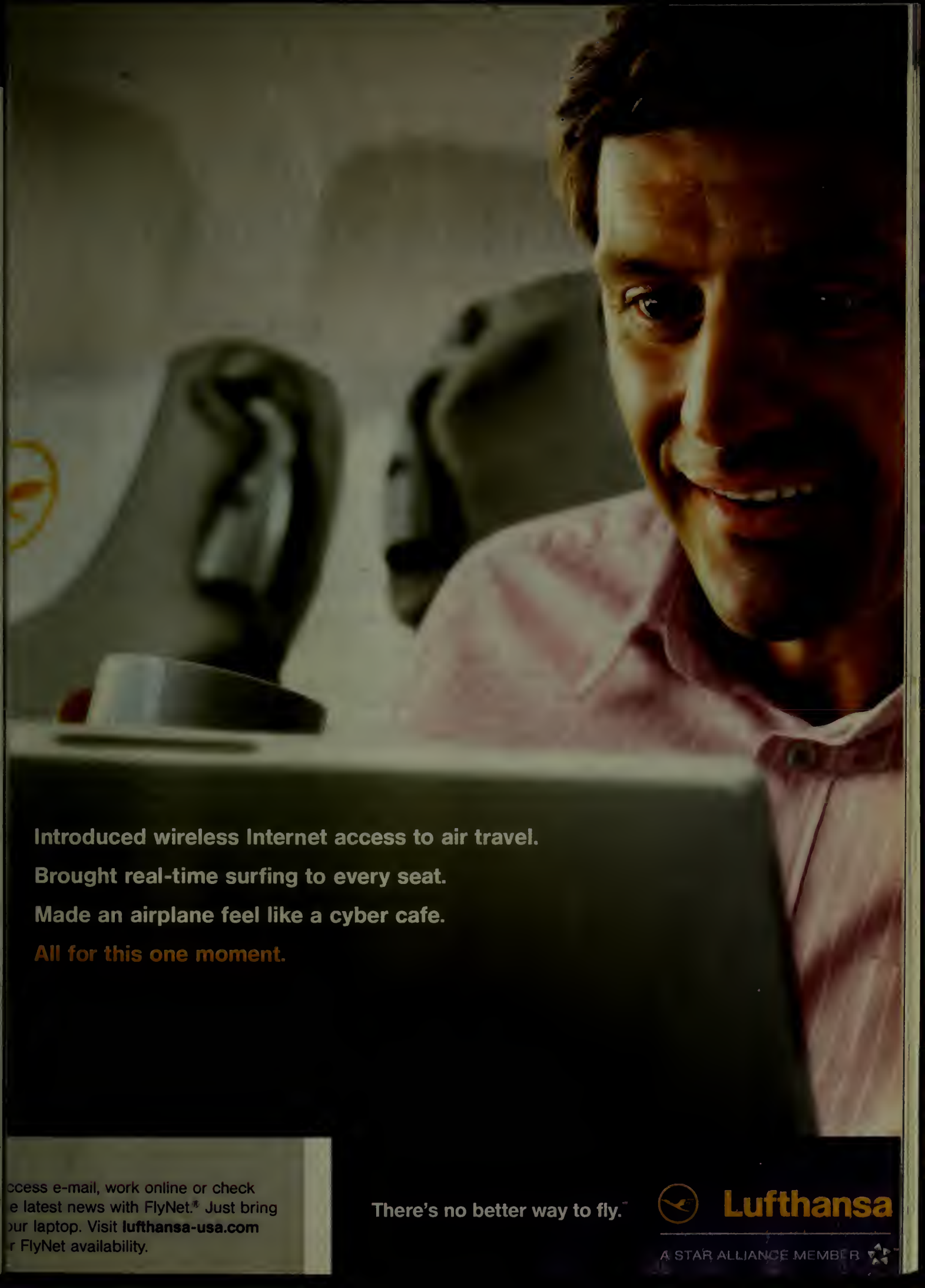
Then there are concerns about whether Samsung is too optimistic in its projections of growth in mobile gadgets. Some forecasters worry that consumer demand for chip-laden devices will slow next year, putting pressure on chip prices. Samsung is betting that its emphasis on customized chips and the most advanced gadgets will insulate it from a downturn.

And if it's wrong? "If mobile phones don't turn out to be the main handheld terminal for consumers, Samsung's scenario won't work," says Koo Bon Jun, a Salomon Smith Barney analyst. Hwang, though, is confident. "You don't wait for the future. You create it," he says. If he pulls it off, he'll have a new reason to gloat. ■

—Moon Ihlwan in Seoul, with Cliff Edwards in San Mateo, Calif., and Otis Port in New York

The Titans of Chips

COMPANY	CHIP SALES, 2004, 1ST HALF
Intel	\$14.9 BILLION
Samsung	\$7.4
Texas Instruments	\$5.4
Renesas Technology	\$4.9
Infineon Technologies	\$4.4
Data: Source: IC Insights	



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A STAR ALLIANCE MEMBER



COMMENTARY

BY DEXTER ROBERTS

Is China Running Out of Workers?

As farmers stay home, factories are scrambling for employees

BACK IN 1989, Taiwanese businessman Hayes Lou moved his bicycle and motorcycle helmet factory from Superior, Mont., to the city of Dongguan, in Guangdong province, China. Over the past 15 years he and his partners have added another helmet factory in Jiangmen and opened a second facility in Dongguan to make plastic packaging materials. The

rapid growth of Lou's business has been made possible largely by one factor, plentiful, dirt-cheap labor.

Now Lou's packaging factory is running well below capacity because he has only been able to find 170 of the 300 workers he needs. And even though he has jacked wages up some 30% since the beginning of the year, to an average of \$85 a month, turnover is getting worse. "Everyone in every kind of factory is short of workers," says Lou, who is deputy director of the Dongguan Taiwan Business Assn.

Looking for a scary scenario for global inflation? You may find it in China. Until now, China's insatiable demand for commodities has not translated into higher prices for the goods it produces for the world. No factory owner in China wants to price himself out of the market. But if labor shortages persist, the resulting wage hikes could show up in the prices we all pay.

Lou's predicament is being replicated throughout China's big manufacturing zones. A recent survey by the Labor & Social Security Ministry found that the Pearl River Delta needs 2 million more laborers. "It's a serious situation if you're a manufacturer, because now you've got to compete on wages," says Jonathan Anderson, Chief Asia Economist at UBS Securities in Hong Kong. "You can't just put up a sign and expect workers to come knocking. That game is over."

Lou says that with both wages and the cost of raw materials rising, he needs to raise prices 30% for his plastic packaging to make a profit. Buyers have balked, and he's only been able to raise prices 10% so far. Yet the upward pressures remain. "Very gradually manufacturing prices of goods will go up," says Anderson.

What happened to the bottomless well of workers? Driven partly by foreign investment, China is building more factories than it



WOMEN WANTED
But demographic policies have resulted in a scarcity of females

can easily find workers for. Factories are also springing up in the hinterlands, partly because of Beijing's Develop the West program, but also as manufacturers seek cheaper land and labor.

A key factor is a paucity of the young women who are the mainstay of manufacturing. According to the Labor & Social Security Ministry survey, 80% of Fujian textile plants report they only hire young women workers. But after 25 years of China's one-child policy, there are fewer young people able to leave the farm and staff the factories. The one-child policy also had the effect of favoring the birth of boys over girls, resulting in a population skewed more toward males. "The surplus labor in rural China may be as high as 100 million to 200 million people," says Zhang Juwei, deputy director of the Institute of Population & Labor Economics at the Chinese Academy of Social Sciences. "But women are well under half of that."

Another factor reducing labor supply is better conditions in rural areas. A major component of China's 5.3% inflation rate is higher food prices, which mean higher incomes for farmers. China's State Council is also slashing agricultural taxes while boosting farm subsidies. "Most young people in my village don't want to leave because they can make money from the land," says Shen Zhiyun, a 27-year-old native of Chengnan in northern Guangdong who now works in a Zhuhai factory. China will not lose its role as the world's workshop. But much of that workshop relied on low margins and dirt-cheap labor—labor that's suddenly not so cheap. The China model is changing fast. ■

—With Frederik Balfour
in Hong Kong

WAGE SPIRAL

Urban labor costs in China have been rising

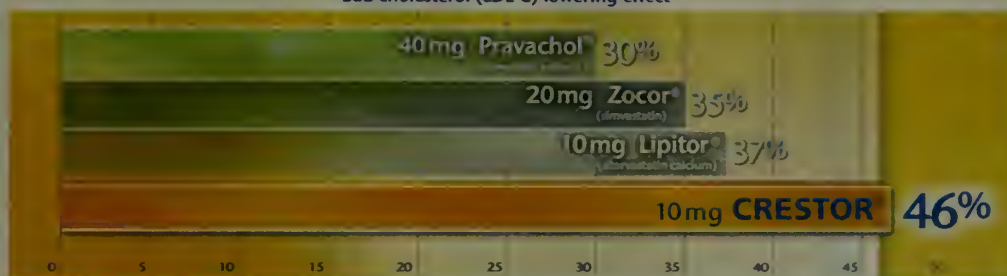


Cholesterol high?

Trouble getting it low?

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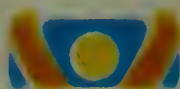
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Important information: CRESTOR is prescribed along with diet for lowering cholesterol and is not for everyone, including people with liver disease, and women who are nursing, pregnant, or may become pregnant. Tell your doctor promptly if you experience unexplained muscle pain or weakness, as they may be a sign of serious side effects. Be sure to tell your doctor about other medications you are taking. Simple blood tests are needed to check for liver problems before and 12 weeks after start of therapy or change of dose, and periodically thereafter. Side effects occur infrequently and include muscle aches, constipation, weakness, abdominal pain, and nausea. They are usually mild and tend to go away. CRESTOR has not been shown to prevent heart disease or heart attacks. See adjacent page for additional important information.

Source: Most commonly prescribed doses based on IMS (August 2003-July 2004).

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Please read this summary carefully and then ask your doctor about CRESTOR. No advertisement can provide all the information needed to determine if a drug is right for you. This advertisement does not take the place of careful discussions with your doctor. Only your doctor has the training to weigh the risks and benefits of a prescription drug.

BRIEF SUMMARY: INDICATIONS AND USAGE

CRESTOR is an adjunct to diet to increase HDL-C and to decrease LDL-C and TG levels in patients with primary hypercholesterolemia and mixed dyslipidemia. CRESTOR is also an adjunct to diet for the treatment of patients with primary hypercholesterolemia and mixed dyslipidemia to reduce LDL-C, total-C, and TG levels. CRESTOR is also an adjunct to diet for the treatment of patients with primary hypercholesterolemia and mixed dyslipidemia to reduce LDL-C, total-C, and TG levels.

CONTRAINDICATIONS

CRESTOR is contraindicated in patients with a known hypersensitivity to this product. Rosuvastatin is contraindicated in patients with active liver disease or unexplained persistent elevations of serum transaminases. CRESTOR is contraindicated in patients with known hypersensitivity to statins or if such treatments are unavailable. CRESTOR is contraindicated in patients with known hypersensitivity to statins or if such treatments are unavailable.

Pregnancy and Lactation

Atherosclerosis is a chronic process and discontinuation of lipid-lowering drugs during pregnancy should have little impact on the outcome of long-term therapy of primary hypercholesterolemia. Cholesterol and other products of cholesterol biosynthesis are essential components for fetal development (including synthesis of steroids and cell membranes). Since HMG-CoA reductase inhibitors decrease cholesterol synthesis and possibly the synthesis of other biologically active substances derived from cholesterol, they may cause fetal harm when administered to pregnant women. Therefore, HMG-CoA reductase inhibitors are contraindicated during pregnancy and in nursing mothers. ROSUVASTATIN SHOULD BE ADMINISTERED TO WOMEN OF CHILDBEARING AGE ONLY WHEN SUCH PATIENTS ARE HIGHLY UNLIKELY TO CONCEIVE AND HAVE BEEN INFORMED OF THE POTENTIAL HAZARDS. If the patient becomes pregnant while taking this drug, therapy should be discontinued immediately and the patient apprised of the potential hazard to the fetus. **WARNINGS: Liver Enzymes** HMG-CoA reductase inhibitors, like some other lipid-lowering therapies, have been associated with biochemical abnormalities of liver function. The incidence of persistent elevations (>3 times the upper limit of normal [ULN]) occurring on 2 or more consecutive occasions in serum transaminases in fixed dose studies was 0.4, 0.0, and 0.1% in patients who received rosvastatin 5, 10, 20, and 40 mg, respectively. In most cases, the elevations were transient and resolved or improved on continued therapy or after a brief interruption in therapy. There were two cases of jaundice, for which a relationship to rosvastatin therapy could not be determined, which resolved after discontinuation of therapy. There were no cases of liver failure or irreversible liver disease in these trials. It is recommended that liver function tests be performed before and at 12 weeks following both the initiation of therapy and any elevation of dose, and periodically (e.g., semiannually) thereafter. Liver enzyme changes generally occur in the first 3 months of treatment with rosvastatin. Patients who develop increased transaminase levels should be monitored until the abnormalities have resolved. Should an increase in ALT or AST of >3 times ULN persist, reduction of dose or withdrawal of rosvastatin is recommended. Rosuvastatin should be used with caution in patients who consume substantial quantities of alcohol and/or have a history of liver disease (see CLINICAL PHARMACOLOGY, Special Populations, Hepatic Insufficiency). Active liver disease or unexplained persistent transaminase elevations are contraindications to the use of rosvastatin (see CONTRAINDICATIONS). **Myopathy/Rhabdomyolysis** Rare cases of rhabdomyolysis with acute renal failure secondary to myoglobinuria have been reported with rosvastatin and with other drugs in this class. Uncomplicated myalgia has been reported in rosvastatin-treated patients (see ADVERSE REACTIONS). Creatine kinase (CK) elevations (>10 times upper limit of normal) occurred in 0.2% to 0.4% of patients taking rosvastatin at doses of up to 40 mg in clinical studies. Treatment-related myopathy, defined as muscle aches or muscle weakness in conjunction with increases in CK values >10 times upper limit of normal, was reported in up to 0.1% of patients taking rosvastatin doses of up to 40 mg in clinical studies. Rare cases of rhabdomyolysis were seen with higher than recommended doses (80 mg) of rosvastatin in clinical trials. Factors that may predispose patients to myopathy with HMG-CoA reductase inhibitors include advanced age (>65 years), hypothyroidism, and renal insufficiency. The incidence of myopathy increased at doses of rosvastatin above the recommended dosage range. Consequently, 1. Rosuvastatin should be prescribed with caution in patients with predisposing factors for myopathy, such as, renal impairment (see DOSAGE AND ADMINISTRATION), advanced age, and hypothyroidism. 2. Patients should be advised to promptly report unexplained muscle pain, tenderness, or weakness, particularly if accompanied by malaise or fever. Rosuvastatin therapy should be discontinued if markedly elevated CK levels occur or myopathy is diagnosed or suspected. 3. The risk of myopathy during treatment with rosvastatin may be increased with concurrent administration of other lipid-lowering therapies or cyclosporine (see CLINICAL PHARMACOLOGY, Drug Interactions, PRECAUTIONS, Drug Interactions, and DOSAGE AND ADMINISTRATION). The benefit of further alterations in lipid levels by the combined use of rosvastatin with fibrates or niacin should be carefully weighed against the potential risks of this combination. Combination therapy with rosvastatin and gemfibrozil should generally be avoided. (See DOSAGE AND ADMINISTRATION and PRECAUTIONS, Drug Interactions). 4. The risk of myopathy during treatment with rosvastatin may be increased in circumstances which increase rosvastatin drug levels (see CLINICAL PHARMACOLOGY, Special Populations, Race and Renal Insufficiency, and PRECAUTIONS, General). 5. Rosuvastatin therapy should also be temporarily withheld in any patient with an acute, serious condition suggestive of myopathy or predisposing to the development of renal failure secondary to rhabdomyolysis (e.g., sepsis, hypotension, major surgery, trauma, severe metabolic, endocrine, and electrolyte disorders, or uncontrolled seizures). **PRECAUTIONS** **General** Before instituting therapy with rosvastatin an attempt should be made to control hypercholesterolemia with appropriate diet and exercise, weight reduction in obese patients, and treatment of underlying medical problems (see INDICATIONS AND USAGE). Administration of rosvastatin 20 mg to patients with severe renal impairment (CL_{CR} <30 mL/min/1.73 m²) resulted in a 3-fold increase in plasma concentrations of rosvastatin compared with healthy volunteers (see WARNINGS, Myopathy/Rhabdomyolysis and DOSAGE AND ADMINISTRATION). Pharmacokinetic studies show an approximate 2-fold elevation in median exposure in Japanese subjects residing in Japan and in Chinese subjects residing in Singapore compared with Caucasians residing in North America and Europe. The contribution of environmental and genetic factors to the difference observed has not been determined. However, these increases should be considered when making rosvastatin dosing decisions for patients of Japanese and Chinese ancestry. (See WARNINGS, Myopathy/Rhabdomyolysis, CLINICAL PHARMACOLOGY, Special Populations, Race) **Information for Patients** Patients should be advised to report promptly unexplained muscle pain, tenderness, or weakness, particularly if accompanied by malaise or fever. When taking rosvastatin with an antacid, magnesium hydroxide, or sodium bicarbonate, the rosvastatin should be taken at least 2 hours after rosvastatin administration. (See CLINICAL PHARMACOLOGY, Drug Interactions). **Laboratory Tests** In the rosvastatin clinical studies, microscopic hematuria were observed among patients taking rosvastatin at doses above the recommended dose range. In patients taking rosvastatin at doses above the recommended dose range, microscopic hematuria were observed among patients taking rosvastatin at doses above the recommended dose range.

Drug Interactions

Cyclosporine: When rosvastatin 10 mg was administered to patients with severe renal impairment (CL_{CR} <30 mL/min/1.73 m²), the plasma concentration of rosvastatin was increased approximately 3-fold compared with healthy volunteers. (See WARNINGS, Myopathy/Rhabdomyolysis and DOSAGE AND ADMINISTRATION).

Pharmacokinetics

Pharmacokinetics: Rosuvastatin is a statin, a class of drugs that inhibit the enzyme HMG-CoA reductase, the rate-limiting enzyme in cholesterol synthesis. Rosuvastatin is a potent inhibitor of HMG-CoA reductase. Rosuvastatin is a potent inhibitor of HMG-CoA reductase.

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Table 1. Adverse Events in Placebo-Controlled Studies

Adverse event	Rosuvastatin N=744	Placebo N=382
Pharyngitis	9.0	7.6
Headache	5.5	5.0
Diarrhea	3.4	2.9
Dyspepsia	3.4	3.1
Nausea	3.4	3.1
Myalgia	2.8	1.3
Asthenia	2.7	2.6
Back pain	2.6	2.4
Flu syndrome	2.3	1.8
Urinary tract infection	2.3	1.6
Rhinitis	2.2	2.1
Sinusitis	2.0	1.8

In addition, the following adverse events were reported, regardless of causality assessment, in ≥1% of 10,275 patients treated with rosvastatin in clinical studies. The events in italics occurred in ≥2% of these patients. **Body as a Whole:** Abdominal pain, accidental injury, chest pain, infection, pain, pelvic pain, and neck pain. **Cardiovascular System:** Hypertension, angina pectoris, vasodilatation, and palpitation. **Digestive System:** Constipation, gastroenteritis, vomiting, flatulence, peridontal abscess, and gastritis. **Endocrine:** Diabetes mellitus. **Hemic and Lymphatic System:** Anemia and ecchymosis. **Metabolic and Nutritional Disorders:** Peripheral edema. **Musculoskeletal System:** Arthritis, arthralgia, and pathological fracture. **Nervous System:** Dizziness, insomnia, hypertonias, paresthesia, depression, anxiety, vertigo, and neuralgia. **Respiratory System:** Bronchitis, cough increased, dyspnea, pneumonia, and asthma. **Skin and Appendages:** Rash and pruritus. **Laboratory Abnormalities:** In the rosvastatin clinical trial program, dipstick-positive proteinuria and microscopic hematuria were observed among rosvastatin-treated patients, predominantly in patients dosed above the recommended dose range (i.e., 80 mg). However, this finding was more frequent in patients taking rosvastatin 40 mg, when compared to lower doses of rosvastatin or comparator statins, though it was generally transient and was not associated with worsening renal function (see PRECAUTIONS, Laboratory Tests). Other abnormal laboratory values reported were elevated creatinine, phosphokinase, transaminases, hyperglycemia, glutamyl transpeptidase, alkaline phosphatase, bilirubin, and thyroid function abnormalities. Other adverse events reported less frequently than 1% in the rosvastatin clinical study program regardless of causality assessment, included arrhythmia, hepatitis, hypersensitivity reactions (i.e., face edema, thrombocytopenia, leukopenia, vesiculobullous rash, urticaria, and angioedema), kidney failure, syncope, myasthenia, myositis, pancreatitis, photosensitivity reaction, myopathy, and rhabdomyolysis. **OVERDOSAGE** There is no specific treatment in the event of overdose. In the event of overdose, the patient should be treated symptomatically and supportive measures instituted as required. Hemodialysis does not significantly enhance clearance of rosvastatin. **DOSAGE AND ADMINISTRATION** The patient should be placed on a standard cholesterol-lowering diet before receiving CRESTOR and should continue on this diet during treatment. CRESTOR can be administered as a single dose at any time of day, with or without food. **Hypercholesterolemia (Heterozygous Familial and Nonfamilial) and Mixed Dyslipidemia (Fredrickson Type IIa and IIb)** The dose range for CRESTOR is 5 to 40 mg once daily. Therapy with CRESTOR should be individualized according to goal of therapy and response. The usual recommended starting dose of CRESTOR is 10 mg once daily. Initiation of therapy with 5 mg once daily may be considered for patients requiring less aggressive LDL-C reductions or who have predisposing factors for myopathy (see WARNINGS, Myopathy/Rhabdomyolysis). For patients with marked hypercholesterolemia (LDL-C > 190 mg/dL) and aggressive lipid targets, a 20-mg starting dose may be considered. The 40-mg dose of CRESTOR should be reserved for those patients who have not achieved goal LDL-C at 20 mg (see WARNINGS, Myopathy/Rhabdomyolysis). After initiation and/or upon titration of CRESTOR, lipid levels should be analyzed within 2 to 4 weeks and dosage adjusted accordingly. **Homozygous Familial Hypercholesterolemia** The recommended starting dose of CRESTOR is 20 mg once daily in patients with homozygous FH. The maximum recommended daily dose is 40 mg. CRESTOR should be used in these patients as an adjunct to other lipid-lowering treatments (e.g., LDL apheresis) or if such treatments are unavailable. Response to therapy should be estimated from pre-apheresis LDL-C levels. **Dosage in Patients Taking Cyclosporine** In patients taking cyclosporine, therapy should be limited to CRESTOR 5 mg once daily (see WARNINGS, Myopathy/Rhabdomyolysis, and PRECAUTIONS, Drug Interactions). **Concomitant Lipid-Lowering Therapy** The effect of CRESTOR on LDL-C and total-C may be enhanced when used in combination with a bile acid binding resin. If CRESTOR is used in combination with gemfibrozil, the dose of CRESTOR should be limited to 10 mg once daily (see WARNINGS, Myopathy/Rhabdomyolysis, and PRECAUTIONS, Drug Interactions). **Dosage in Patients With Renal Insufficiency** No modification of dosage is necessary for patients with mild to moderate renal insufficiency. For patients with severe renal impairment (CL_{CR} <30 mL/min/1.73 m²) not on hemodialysis, dosing of CRESTOR should be started at 5 mg once daily and not to exceed 10 mg once daily (see PRECAUTIONS, General, and CLINICAL PHARMACOLOGY, Special Populations, Renal Insufficiency).

NOTE: This summary provides important information about CRESTOR. For more information, please ask your doctor or health care professional about the full Prescribing Information and discuss it with them.

Rx only

Reference: IMS National Prescription Audit (August 2004)

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EDITED BY ROSE BRADY

Japan: Quickly Leaving Pacifism Behind

THREATS OF ECONOMIC SANCTIONS against North Korea, possible preemptive military strikes, and a missile defense system buildup—welcome to the new, and surprisingly robust, Japanese national security policy. If there is a distinctive feature of Prime Minister Junichiro Koizumi's stint in power, it is the rollback of the pacifism that has marked Japan's relations with the world.

Koizumi's latest move occurred on Oct. 4, when Japan moved closer to becoming a more serious military player on the global stage. A defense panel reporting to Koizumi called for measures aimed at overhauling the country's 1995 National Defense Program Outline. These include easing restrictions on missions that Japan's 255,000 Self-Defense Forces (SDF) can undertake abroad, loosening a decades-old ban on arms exports by Japan, and developing the capability to attack foreign missile bases—a thinly veiled threat to North Korea.

Leery Neighbors

WITH U.S. BACKING, Japan is also pressing to gain a permanent seat on the U.N. Security Council. The new Defense Program Outline, expected to be approved by yearend, is likely to strengthen the U.S.-Japan alliance even further—and Japan's neighbors aren't so sure they like what they see. "The Chinese and Koreans are leery of anything Japan does," says William T. Breer, a Japan expert at Washington's Center for Strategic & International Studies.

Japan, at this dangerous moment in global affairs, doesn't seem concerned about protests from Beijing or Seoul. Koizumi and his Cabinet just want to keep up the momentum they have built since the 2001 terrorist attacks in the U.S. At that time, Japan's Diet approved a law that freed SDF naval forces to provide logistical support to the U.S. invasion of Afghanistan. Tokyo has also sent hundreds of peacekeepers to Iraq. Last year, Japan launched

its first-ever military spy satellites to track North Korean missile installations. And earlier this year the Diet gave Koizumi freedom to impose economic sanctions on North Korea without U.N. backing.

The get-tough approach with Pyongyang is surprising, given the studied inaction of Tokyo's North Korea policy. Japan's hawkish new Foreign Minister, Nobutaka Machimura, has voiced frustration about North Korea's foot-dragging in resolving cases involving abduction of Japanese citizens. "A time limit is necessary at some point, and we must consider such options as sanctions," he recently told the newspaper *Nihon Keizai Shimbun*. Such tough talk

goes over well with the public, which understands that North Korean Rodong missiles, with an 800-mile range, could blanket most of the Japanese archipelago.

Small wonder then that Japan is pushing to develop a missile defense system with the U.S. Washington recently moved naval destroyers armed with Aegis missile tracking and intercept systems near North Korea. Japan hopes to install a jointly developed system on its own ships. That would mean exporting weapons technology to its U.S. partners—a reversal of Japan's self-imposed ban on selling arms abroad.

Ultimately, Koizumi would like to revise the clause of the Japanese Constitution that renounces war, thus making it possible for Tokyo to form a military truly capable of projecting power abroad. Such a major change will be a tough sell. But Japan now lives in a rough neighborhood, and it knows it needs to get tough fast. ■

—By Brian Bremner and Hiroko Tashiro
in Tokyo, with Stan Crock in Washington



ON THE MARCH?
Restrictions on the army may be loosened

GLOBAL WRAPUP

A BIG TAX HIKE ON OIL MAJORS IN VENEZUELA

VENEZUELA'S MERCURIAL President, **Hugo Chávez**, took foreign oil companies by surprise on Oct. 10 by decreeing a tax hike from 1% to 16.7% on heavy crude oil projects in the Orinoco Belt. The decision, effective immediately, means the Venezuelan government will raise close to \$800 million in royalties annually from projects controlled by ConocoPhillips, ChevronTexaco, ExxonMobil, Total, BP, and Statoil, officials say.

With oil prices at record highs, the government says the projects no longer need the tax holiday they were granted in the 1990s. And after consolidating his power in an August referendum, Chávez is looking to deepen his populist revolution during his two remaining years in power—with the oil industry footing the bill.

ISRAEL'S SHARON FACES A SHOWDOWN

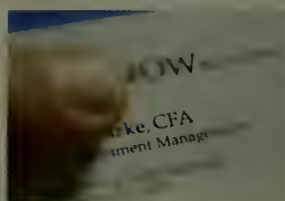
ISRAELI PRIME MINISTER **Ariel Sharon** is planning to hold a vote in the Knesset on his controversial "disengagement plan," despite growing opposition from within his own Likud Party. Sharon will put the plan, which involves evacuating all Jewish settlements in the Gaza Strip and four in the northern West Bank, before the Knesset on Oct. 25.

Nearly half of Likud's 40-seat Knesset faction opposes the disengagement plan. If Sharon can't muster support from Labor and other opposition parties, he may have to call national elections more than two years ahead of schedule. Sharon's policy statement at the opening of the Knesset session on Oct. 11 failed to win a majority, a first in Israeli history.

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CHOOSING A FINANCIAL ADVISOR

or Not

Today's investing and money management climate may simply be too much of a good thing.

Thousands of mutual funds and stocks. Battalions of bonds and fixed-income options. And, finally, the Internet, a bottomless source of investing information but, at the same time, an equally generous source of confusion and frequent misinformation.

Simply put, keeping your finances on track can be a dwarfing proposition for many investors. And that can make finding a suitable financial advisor more critical than ever before.

"The financial landscape has become nothing but more complex over the past several years," says Bob Johnson, executive vice president of the CFA program at the CFA Institute in Charlottesville, Va. "Not only has the development of the Internet actually complicated things by providing an untold amount of information, people are simply busier than they ever have been. The amount of time they can devote to financial affairs is less."



FIRST, KNOW YOURSELF

Before starting out on a search for the financial advisor who's right for you, however, it's helpful to do a bit of financial introspection. Consider what your financial goals and needs might be. If, for instance, all you're interested in is investment guidance, a stock broker may be perfectly suitable. But, if your financial picture is more involved—say, estate planning and funding a college education are also in the mix—you may want to pursue a financial planner whose services go beyond investment advice.

No matter your initial thoughts, one way to begin is to ask family, friends and relatives for referrals. Find out if they happen to be working with someone with whom they're satisfied. In particular, ask for referrals from others whose financial situation is akin to your own. That way, you're targeting financial pros with experience with others dealing with similar issues.

From there, investigate other options ranging from traditional full-service brokerage houses such as Merrill Lynch to banks such as JPMorgan Chase, insurance companies and large financial concerns such as American Express. As interest in financial advising has blossomed in recent years, so have varied companies programs and offerings, from simple brokerage services to comprehensive financial and estate planning.

It can also be useful to approach professional financial organizations. For instance, the CFA Institute provides referrals to advisors who have earned the Chartered Financial Analyst (CFA) designation. Many financial institutions offer similar networks. For instance, TD Waterhouse offers AdvisorDirect, a national independent advisor financial referral program.

"A high level of interpersonal trust is the key to long-term financial advisor-client relationships," notes J. Thomas Bradley, president of TD Waterhouse

Institutional Services. "The first rule about selecting a financial advisor is that you must spend an adequate amount of time looking for and assessing their qualifications."

Finally, think about how much of a role you want to play in your financial affairs. Some clients will largely defer decisions to an advisor, while others will be more comfortable in having at least a hand in responsibilities such as choosing suitable investments.

"Make sure you spend some time thinking about the level of involvement you would want an advisor to have," says Michael Klena, vice president of retail brokerage at E*Trade Financial. "If you want to delegate all decisions, fee based advisors designation might be best for you. However, if you would like to be more involved, a large financial firm such as ours might be a better choice given the breadth of products available."

THE INTERVIEW

That means it's important to adopt a systematic program of preplanned interviews with any financial professional you may be considering. It's a good

"The first rule about selecting a financial advisor is that you must spend an adequate amount of time looking for and assessing their qualifications."

idea to interview no less than three candidates. That should offer a reasonable mix of feedback and help you focus on those issues that are most important.

Here's a lineup of suggested questions and target issues you may wish

to include:

- Ask about qualifications, including special designations and training.
- What's the advisor's investment style? Hook up with an advisor who, for instance, is far more aggressive than you are, then you're likely facing a relationship that's doomed from the start, not to mention a parade of sleepless nights. "Never underestimate chemistry," says Mary-Jo Iacovino, a financial consultant at AXA Advisors in New York. "Choosing an advisor should be very personal."
- What sort of clients does he work with? Are they similar to your financial situation?
- Has she ever been disciplined? If so, for what?
- Will he service your account or will it be someone else? Many high-ranking executives in financial firms bring in clients, only to hand many off to subordinates.
- How often will she communicate with you? Some clients want ongoing contact with their financial advisors; others only want to be bothered when something of significance occurs.
- What's the firm's policy on employee trading of securities? This is yet another potential pitfall. If a well-defined policy is not in place, it can potentially lead to a conflict of interest, such as an advisor pushing a stock that he owns himself.
- Can he refer you to other clients with whom he has worked in the past? Ideally, aim for clients who have been with the advisor for at least several years. That will give you the best indication of the quality of the advisor's long term guidance.

WATCH FOR RED FLAGS

Although circumstances will differ according to individual situations, you should also keep an eye peeled for several rather telling warning signs that may crop up in an interview. One of the most suspicious is a refusal to let you talk with other clients with whom an advisor has worked. Any advisor who balks at this



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may be saddled with an array of dissatisfied clients who may be more than happy to discuss his shortcomings.

So, too, be wary of any reluctance on the advisor's part to offer specifics when asked. Again, any discomfort or inability to explain anything to your complete satisfaction may suggest an advisor with something to hide or one whose knowledge of the topic at hand isn't as extensive as it should be.

A third sign is straightforward: be wary of too heavy a sales pitch and not enough interest in what you need. Notes Sandra Salter, owner of the American Express Financial Advisors Branch in Newark, N.J.: "The advisor should not be trying to make a sale. If you feel as if you are being rushed into buying a certain product at an initial meeting or if something sounds too good to be true, such as a guarantee for unbeatable returns on investments, seek out another advisor."

Yet another warning signal is undue emphasis on short-term results. If all an advisor wants to address is last month or one year in particular, ask why he's avoiding the longer term. Notes E*Trade's Klena: "Watch out for advisors who focus on the short term. The basic tenet of financial advice is to focus on reaching financial goals. And that may take some time."

One final caveat is not so much what occurs in the interview at what might not. Come to your meeting armed with questions, but be wary of an advisor who doesn't pose his own questions to you as well. Any advisor who doesn't try to gain at least a modest understanding of your financial makeup and goals probably won't take the time to back fill that knowledge later on. "It's best to avoid advisors who talk about products or investments right off the bat without first discussing your financial concerns," says William J. Connington III, owner of the Connington

Wealth Management Group in Pine Brook, N.J.

CONSIDER COMPENSATION

Yet another issue you should pursue in the interview is compensation. Just how an advisor earns her living can come by way of a variety of arrangements, ranging from hourly rates to a flat fee to commissions based on the products you buy. Like other elements that go into the decision of which advisor to work with, compensation can be a matter of personal preference. Some clients will like the predictability of a flat fee, while others may not mind paying commission in hopes that it might cost them less in the long run than a set amount.

"It's best to avoid advisors who talk about products or investments right off the bat without first discussing your financial concerns."

However, financial pros generally suggest that customers avoid compensation arrangements that are purely commission-based. If nothing else, that can lead to potential conflicts of interest, as advisors push products that may offer the highest commission but which, in fact, may not be suited to many clients. Even the very hint of conflict can sour a relationship. Notes TD Waterhouse's Bradley: "A financial advisor who collects commissions is open to the criticism that he or she has an incentive to select or recommend investments partly on the basis of the commission offered and not solely on the quality of the investment."

FOR THE DO-IT-YOURSELFER

Of course, there will always be investors who prefer to live by their own wits. If that's the case, it's critical

to seek out resources that will effectively supplant an advisor's guidance. For instance, TD Waterhouse provides Financial Engines software in its branch offices. An asset allocation system, the program lets customers build new portfolios or adjust existing investment allocations. From there, check a firm's other resources, including research reports and available analysis. Investigate the fee structure as well.

It's also best to evaluate your situation and skills carefully before committing to investing on your own. Ask yourself if you'll be genuinely willing to put in the time and effort to build and monitor an investment portfolio. A financial plan needs both building and babysitting, and that will mandate substantial homework and legwork.

If you doubt you have the time or the necessary discipline to go it alone, it may be best to opt for the direction and experience that a financial advisor can offer. As the CFA Institute's Johnson puts it: "Do you think most of us have the ability to be a do-it-yourself doctor? It's usually worth a small percentage of your wealth to work with a solid financial advisor."

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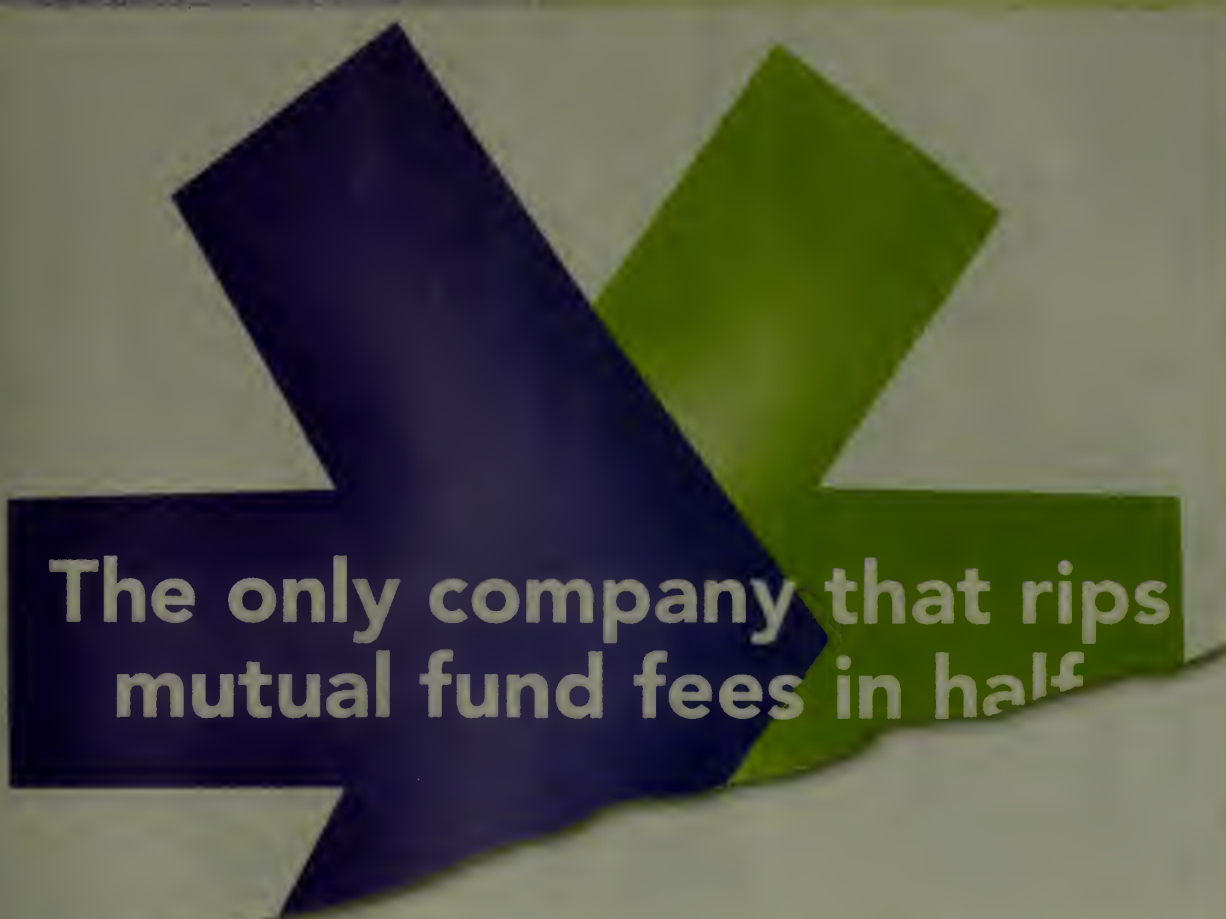
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MANHATTAN The 23rd Street store is geared toward apartment living



Thinking Outside The Big Box

Home Depot ratchets up growth—by moving past the lumberyard look

EARLY LAST YEAR, BELEAGUERED store managers at Home Depot Inc. were drowning in paperwork. Endless communiqués from national, regional, and district headquarters bombarded them with demands to change a kitchen display or to restock screws. “We’d get a fax, an e-mail, a call, and a memo, all on the same project,” says Michael A. Jones, former manager of a Home Depot in Thornton, Colo. Even staffers back at headquarters in Atlanta saw how ridiculous things had become. One exec managed to wallpaper an entire conference room—floor to ceiling, windows included—with just three weeks’ worth of memos.

When store managers complained to Chief Executive Robert L. Nardelli about the paper blizzard in March, 2003, he moved fast to stamp out one of the last vestiges of the company’s old lumberyard style of management. He told his top managers to ax duplicate communications and streamline work projects. Directives not related to work orders had to be sent separately and only once a month. Meanwhile, the company spent \$2 million on workload management software. Today, that system automatically blocks new work orders if current tasks are still on the docket. And in rigorous Nardelli fashion, when a to-do

list for managers arrives electronically, it is marked in green. If it isn’t done by the set date, it changes to red—and district managers can pounce.

Nardelli, former head of General Electric Co.’s Power Systems unit, is remaking Home Depot, and doing it in classic GE style. He’s betting big on technology to boost productivity while plunging into services, this time to profit from those who want home improvements done for them. There is also a push to innovate with spiffy new store designs, and a move into largely untapped foreign markets such as China, where the company is scouting locations.

A REAL REVAMP

ALTOGETHER, IT’S AN approach that relies less on hawking hammers and nails from 150,000-square-foot orange boxes and more on carving out lucrative new niches in the home-improvement market. Despite being pummeled early on for dismal customer service and weak earnings, Nardelli has stuck to his strategy. In the past three years he has spent \$2 billion on technology, including inventory-management systems and Web-based kiosks in stores that offer shoppers access to thousands of special-order items. Those upgrades helped raise operating-profit margins by 0.8% in the second quarter, to 12.3% (compared with 11.7% at archrival Lowe’s Cos.), according to Lehman Brothers analyst Alan M. Rifkin. Meanwhile, the push to sell services, such as kitchen and bath installation, and a higher-margin mix of house-brand and national-brand goods also has perked up profits.

The bottom line: Analysts and investors believe the \$65 billion home-improvement giant—which ranked No. 22 on this year’s BusinessWeek 50 list of the best-performing large public companies—is at last regaining the form that made it an innovator during the ’80s and early ’90s. In the second fiscal quarter, ended Aug. 1, revenues rose 11%, to a record \$20 billion, helped by the boom in home construction and remodeling. Profits climbed 19%, to \$1.55 billion, exceeding Wall Street’s expectations. Home Depot’s average sales ticket rose 8% from a year earlier, to \$54.73, as consumers shrugged off rising gas prices and interest rates to stock up on everything from patio furniture to \$1,000 GE Adora refrigerators. Lehman Brothers’ Rifkin thinks that revenues will top \$72 billion in fiscal 2004, with profits of \$4.9 billion. Meanwhile, the stock is



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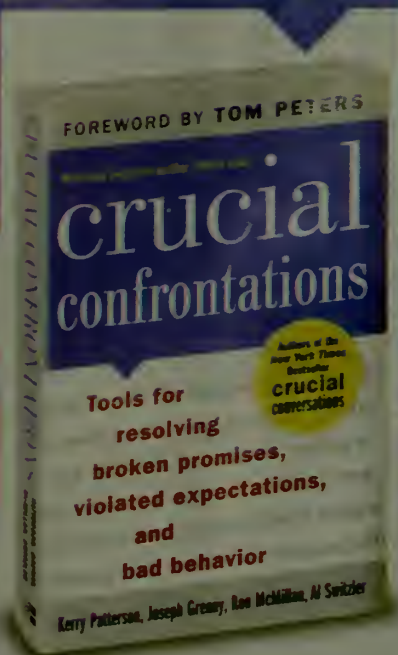

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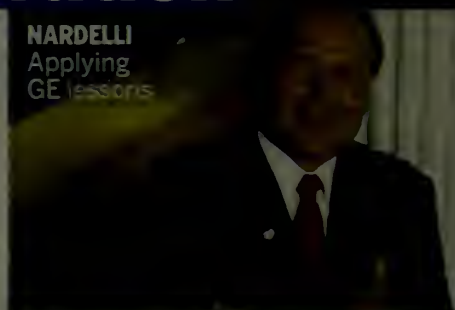
trading around \$40, a 52-week high.

Just as important, Nardelli is finally easing out the ghosts of co-founders Bernard Marcus and Arthur M. Blank. The legendary pair developed Home Depot from a single Atlanta store in 1978 into a chain that epitomized big-box success. But by the time Nardelli took over in December, 2000, Home Depot had lost its competitive edge. Its stores looked like lumberyards, while Lowe's had modern stores and carried upscale goods aimed at women shoppers, rather than Bob Vila wannabes. "Arrogance breeds complacency, and complacency breeds failure," says Nardelli. He began undoing part of the Marcus and Blank legacy by centralizing purchasing to achieve economies of scale, and he made sure inventory was restocked outside store hours, to allay complaints about messy aisles. And, of course, he attacked the paper blizzard that was burying his store managers. Says Kenneth G. Langone, a Home Depot co-founder, director, and, with 17.5 million shares, its second-largest individual stockholder: "There's no doubt that Bob Nardelli is the spiritual leader of Home Depot now."

Like many other GE alums, Nardelli relies on reams of data to drive innovation. To figure out how to design the new Manhattan store, for example, executives conducted 400 telephone surveys with New Yorkers, and 200 with local contractors. The result: a gleaming, two-story, 105,000-sq.-ft. operation with 7% of its floor space dedicated to closet designs—for those tiny city apartments—and a kitchen and bath department so popular that it now has a five-week wait for appointments. And those Web-based kiosks are expected to become self-service, credit-card checkout counters as soon as next year. Look for more variations on this theme: Of the 185 new stores that Home Depot plans to open this year, one-fifth will depart from the traditional big-box layout. "In 2005 and beyond, new stores will be designed for the neighborhoods that they are in," says Chief Financial Officer Carol B. Tomé.

Nardelli still has his work cut out. Lowe's, with its bright, clean stores, remains Wall Street's home-improvement darling. The 1,019-outlet chain has led the industry in total sales gains, on a percentage basis, every quarter except one for the past three years. Its stock price, now at \$54, has more than doubled in the past four years. That's a sore point for Home Depot execs. Although the company's stock has almost doubled in price since the beginning of 2003, it is still down 9% since Nardelli took over.

NARDELLI
Applying
GE lessons



Operation Rehab

After a rough start, CEO Robert Nardelli seems to be succeeding with his makeover of Home Depot.

TECH INJECTION The company has spent \$2 billion on technology improvements, from in-store Web kiosks to automatic inventory restocking systems.

WE'VE GOT GOODS Margins on house brands and exclusive lines like GE's Adora refrigerators can be as much as 10% higher than other goods.

THIS STORE'S FOR YOU A fifth of the 185 stores being added this year ditch big-box design for new formats.

GOING ABROAD Home Depot's 42 stores in Mexico and 108 in Canada are expected to grow at more than twice the rate of the U.S. market. Next on the expansion front: China.

One reason for the lagging stock price, say analysts, is that investors are still doubtful that Nardelli can deliver sustained profits, after years of neglect. What's more, with the shift toward services, some analysts find it more difficult to predict Home Depot's profits accurately. Determining margins on 27 different types of at-home installations, or custom interiors, is far trickier than using traditional sales-per-square-foot figures. And while services were just 5% of sales in 2002, they could total 15% of sales by 2010, according to UBS Securities.

Even now, Home Depot is pushing the limits of customer service. Its techies are toying with using projected human images, like those in the Steven Spielberg film *Minority Report*, as sales tools. At the touch of a button, they would pop up, say, on the side of a dishwasher or refrigerator to offer tips about the appliance. They could begin showing up in some stores as early as next year. But unlike those ghosts, Nardelli's makeover appears rock solid. ■

—By Brian Grow in Atlanta

BusinessWeek online For an interview with Home Depot's Robert Nardelli, go to www.businessweek.com/magazine/extra.htm



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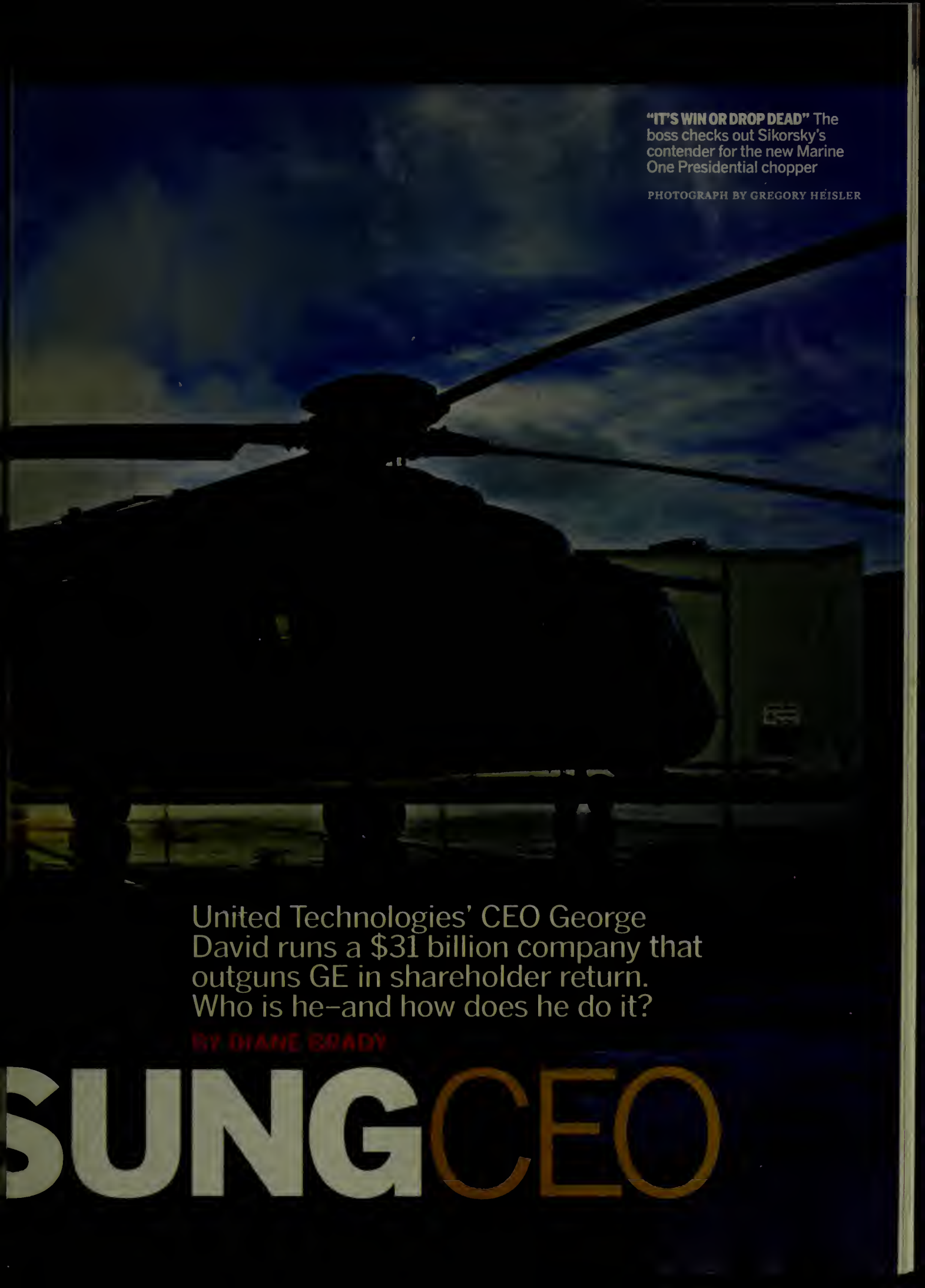
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MANAGEMENT



THE UN



"IT'S WIN OR DROP DEAD" The boss checks out Sikorsky's contender for the new Marine One Presidential chopper

PHOTOGRAPH BY GREGORY HEISLER

United Technologies' CEO George David runs a \$31 billion company that outguns GE in shareholder return. Who is he—and how does he do it?

BY DIANE BRADY

SUNGCEO

E

VEN TO HIS CLOSEST friends, George David of United Technologies Corp.

comes off as a study in contrasts. He will speak passionately about the problem of the country's growing income gap between rich and poor before a crowd of factory workers at UTC's Carrier air conditioner plant in Collierville, Tenn.—though he himself took home a pay packet worth \$70 million last year. When one man raises his hand to ask bluntly about local jobs,

David launches into a monologue about relative labor values in a global economy. Before anyone can write off their leader as heartless, David's eyes tear up while recalling Yuzuru Ito, the late quality guru who helped him formulate his guiding principles of leadership. Then again, while touring the plant, he has barely a glance for the crowd of beaming employees—many of whom have never met him or anyone else from headquarters before. Perhaps the raised eyebrows of one line worker as the boss swings by his station says it all: Who is this guy?

Getting a handle on George David isn't easy. An ardent student of both history and management, he has the air of an academic and talks like some modern-day Plato in a production plant. But David, 62, is more than just a head-in-the-clouds theorist. He has transformed his old-line industrial conglomerate into a \$31 billion powerhouse of productivity with relentless attention to detail. He has taken what are essentially commodity products such as elevators and air conditioners and, thanks to constant innovation and superior technology, turned them into high-margin businesses that dominate from Boston to Beijing. He pontificates on abstruse historical and macroeconomic issues one minute and obsesses over a tiny improvement in the farthest corner of the UTC empire the next. And while he can terminate thousands of workers at a stroke in the name of efficiency, he also has crafted one of the most progressive employee education programs



in the world—even extending benefits to laid-off workers.

Together, these disparate impulses have yielded big results. In David's decade at the helm, in fact, this philosopher king of manufacturing has more than quadrupled earnings per share and outperformed even the mythic General Electric Co. in returns to investors. UTC's total returns have risen about 600% in the past 10 years, vs. roughly 400% for GE. Operating margins have expanded from 6% to 14%. From a steady 3% profit growth when he became chief executive in 1994, UTC today more often delivers double-digit earnings. In the first six months of this year, net income grew 25%, to \$1.4 billion, while sales increased 26%, to \$18.3 billion, in part because of tax settlements and the \$1 billion acquisition last year of building-security giant Chubb PLC. But strip all that out, and underlying growth was still 9% in the first half. Unglamorous though it might be, Hartford-based UTC has been among the top five performers in the 30 companies that make up the Dow Jones industrial average for the past three years. Yet David has won little fame for his achievements unlike former GE chief Jack Welch or even former Honeywell International Inc. CEO Lawrence A. Bossidy, who says with a laugh "Maybe he's just humbler than us."

David has racked up these results despite his penchant for controversial investments that don't directly benefit the bottom line, at least not within any normal time horizon. Hi-

In a decade, David has more than quadrupled earnings

SCHOLAR CEO
David has given
UTC workers
the wherewithal
to study

Employee Scholar Program costs a cool \$60 million a year, and workers don't even have to tie their studies to the job. Anything goes, from medieval poetry to medical training, with UTC picking up the tab, including the cost of books and time off. David also likes to move early—very early—to fund new technologies, such as fuel cells. Such efforts drain millions from the bottom line each year. Yet David believes these initiatives are the seed corn that will grow into businesses that can sustain the company long after he has left office. Ari Bousbib, who heads up UTC's Otis Elevator Co. unit, argues that such investments are better suited to venture-capital companies than manufacturing conglomerates, but, he says, "George looks at a 20- to 50-year time frame."

Proud to lead a conglomerate

DAVID ALSO HAS EMBRACED a corporate structure that many had written off, the industrial conglomerate. UTC's widely varied corporate offspring include Hamilton Sundstrand aerospace systems, Sikorsky helicopters, and the recently acquired Chubb. These units derive little of their identity from UTC. While being called the head of a conglomerate may drive GE's Jeffrey R. Immelt crazy (he prefers "multi-business growth company"), it makes George David proud. In his view, "balance works." His company is just as diverse when it comes to geography. UTC's operations span the globe, with some 2,000 offices outside the U.S.

What ties it all together is that each of UTC's businesses involve basic manufacturing—operations that are susceptible to quality improvements, efficiency improvements, and technological improvements. The ability to continually wring out incremental gains in those areas—David calls them "process disciplines"—is UTC's greatest strength.

When asked how much new technology has contributed to the productivity revolution at UTC, David puts his thumb and index finger together in a circle and says, "zero." He adds that

HEAVY METAL

How UTC's major units stack up against the competition

Otis Elevator Co. Grade: A+	Flight Systems GRADE: A-	Carrier GRADE: B+	Pratt & Whitney GRADE: B-	Chubb GRADE: C
Revenues \$7.9 billion Operating Profits \$1.4 billion	Revenues \$5.7 billion Operating Profits \$785 million	Revenues \$9.2 billion Operating Profits \$911 million	Revenues \$7.5 billion Operating Profits \$1.1 billion	Revenues \$1.1 billion Operating Profits \$55 million
With thousands of sites and 79% of sales outside the U.S., the world's largest elevator and escalator company gives its parent an incredible global reach. And its record of constant innovation and smart acquisitions keeps competitors at bay.	The maker of Sikorsky helicopters and Hamilton Sundstrand aerospace systems is at the top of its game. But competition looms, including a big fight to hold on to the contract to make and maintain Marine One, the Presidential helicopter.	Once the most dysfunctional unit at UTC, the massive air conditioning, ventilating, and heating systems division has become an evangelist of David's productivity push. Still, those plant closures produce a lot of pain for the workers.	Its engines continue to power the world's top fighter jets. Recent losses of big commercial engine orders, though, mean that Pratt & Whitney could become a smaller piece of the UTC pie.	If you're already selling elevators and air conditioners to customers worldwide, it makes sense to throw in fire detection and security systems. But David has to whip this acquisition into shape.

Financial data is for 2003 Data: United Technologies Corp., BusinessWeek

MANAGEMENT

technology has been critical to product innovation and improved communications, but the bulk of gains in the plant comes from better processes, not better machines. Says David: "It's mostly a mindset."

That focus on process is one reason the company shuns financing and other businesses to which those skills don't apply, as well as businesses that simply have no pricing power. The focus on continuous improvement allows UTC to extract gains, even when times are tough. Marvels Steve DeFrancis of investor Mellon Private Wealth Management Group: "They went through the whole downturn without missing a beat."

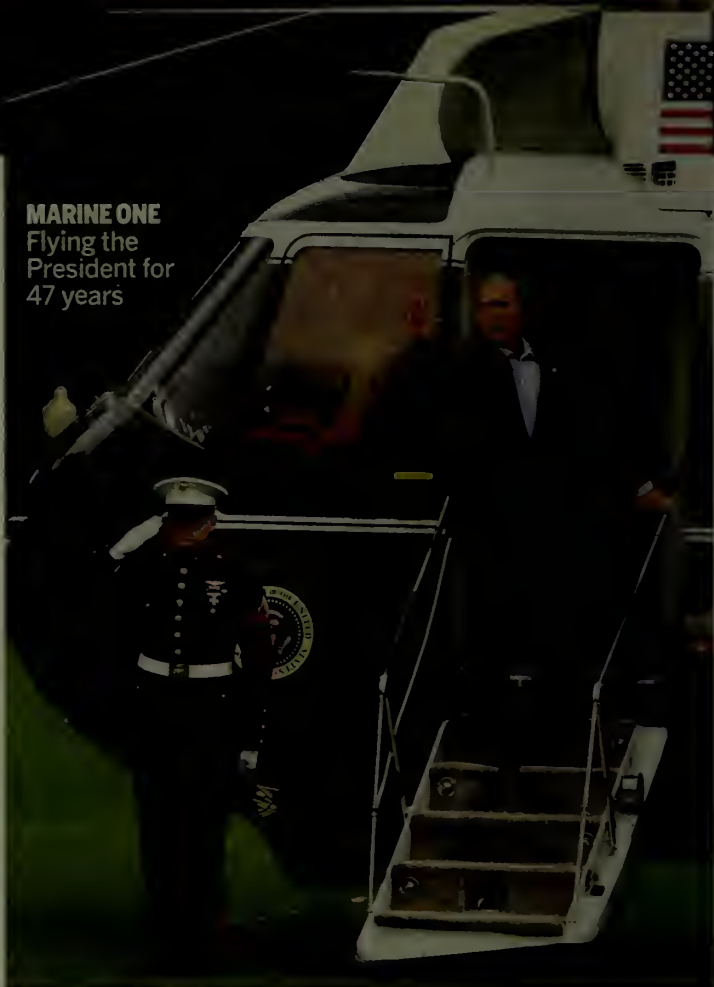
As the patrician leader steps into his second decade in charge, the challenge is how to make the beat go on. He has no plans to leave the job for at least several more years (though he says the board reviews succession plans at every meeting), and he has set lofty goals for the rest of his tenure. Foremost among them is to push UTC's operating margins as high as 20%. It's a high bar, but David insists that UTC has a long way to run in boosting productivity. For one thing, few plants have yet to fully streamline, says Tesfaye Aklilu, vice-president of quality and manufacturing. "We are in the early stages of our lean journey." Acquisitions will also help. Take Chubb. Not only do its security and fire-alarm systems fit nicely with a company that sells elevators, heating, and air conditioning, but its 5% margins give UTC room to improve. And David says a constant influx of new technology from UTC's labs will increase the efficiency of products and manufacturing techniques.

Don't forget about divestitures

NO REVOLUTION LASTS forever, and U.S. executives are starting to wonder whether the productivity boom has run its course. There are many who fear that the unrelenting focus on slashing costs and making fewer people do more has extracted a toll on innovation. David doesn't buy that, noting that UTC spends more than \$2.5 billion a year on research and development, spawning more than 350 patents a year since 1990 and industry-altering products such as Gen2 elevators, which operate without steel cables, or fuel cells that convert waste heat to air conditioning.

David says he'll continue to look for both acquisitions and divestitures as a way to drive growth. Such moves have helped triple UTC's book value over the past decade. What he gets rid of is just as important as what he buys. He says that dumping UT

MARINE ONE
Flying the
President for
47 years



Automotive on Lear Corp. for \$2.3 billion in May, 1999, was "the happiest day of my life." The reason: Auto makers put such a squeeze on suppliers that it was impossible to make decent margins. A few weeks later, UTC picked up aerospace and industrial systems giant Sundstrand Corp. for \$4.3 billion, merging it with existing operations to become Hamilton Sundstrand. That unit has been a home run, winning almost every major system it could bid on in Boeing Co.'s 7E7, with orders totaling \$6 billion. In 2000, David was within a hair of acquiring Honeywell International for about \$40 billion in stock before GE's Jack Welch jumped in to grab it—though Welch later lost it when the European Union's competition commissioner Mario Monti nixed the deal. David also has beefed up Carrier Corp. and Otis with a series of smaller acquisitions that give them a stronger presence in key markets, as well as reach into new technologies.

Still, life hasn't been easy lately in David's Republic. In a world that is fast converting even sophisticated technologies into ho-hum commodities, UTC's unrelenting push to improve quality is a matter of survival. Alarm systems and air conditioners don't exactly have high barriers to entry. China and Russia are becoming competitors as well as customers. High domestic wages and greater efficiencies have resulted in 52 plant closings since 1996—and it's far from done. UTC plans to cut an additional 2,800 from its 203,000-strong global workforce and cut manufacturing space by 6.3 million square feet through next year. That's on top of 36,000 employees who have lost their jobs since 1999.

Then there is the protracted hand-wringing over UTC's two aerospace operations. David admits to being thrown off guard last February by the U.S. Army's cancellation of the \$39 billion Comanche helicopter program with Sikorsky and partner Boeing. Black Hawk orders should fill the gap but, even so, some 700 jobs could be lost. Sikorsky is also locked in a fierce battle against Europe's Agusta-Westland to hold on to its contract to make the Presidential helicopters, known as

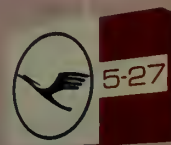
A TALE OF TWO RIVALS

UTC outguns GE in shareholder returns





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MANAGEMENT

Marine One. There's more than prestige at stake. With all the after-market support and sophisticated technology on the 27 or so helicopters that would be ordered, David says "you almost can't put a value on it."

But he is so confident of the lightweight state-of-the-art machine UTC has put forward, the VH-92, that he refuses to contemplate the possibility of losing the contract. He half-jokes that he'll step out of a plane if it happens—after the head of Sikorsky steps out first. "It's win or drop dead," glowers David over a can of Diet Coke and chocolate truffles in the company's corporate jet. "We've flown the President for 47 years!"

An illustrious history, however, hardly guarantees success. Witness the shrinking heft of engine maker Pratt & Whitney, which makes up almost a quarter of UTC's sales and slightly more of its operating profits. Pratt has already lost the coveted bid to outfit Boeing's planned 7E7 Dreamliner airplane, which went to General Electric and Rolls-Royce in April. And it's not just the Boeing contract. The once dominant jet-engine unit has seen rivals grab the bulk of new commercial business in recent years. That worries some analysts as Pratt's shrinking installed base of large engines will mean lower service and spare parts sales in years to come. The problem? In large part, an unwillingness on David's part to give in on price.

Basically, he's willing to cede some commercial business to focus on lucrative defense contracts—even if it means shrinking the business. Pratt President Louis R. Chênevert says that if he were doing the Boeing bid all over again he wouldn't change anything because, in the end, the deal had to be good for shareholders as well as the customer. Still, it's not all bad news. Pratt is the undisputed leader in military engines and is pushing for more sales in the regional jet market. And Korean Air's recent \$500 million order for Pratt engines on its 777 and 747 planes shows the company isn't dead in the widebody market.

As business ebbs and flows, it's workers who often pay a dreadful price. But David doesn't lose any sleep over workers caught in the realities of a global economy. He is achingly blunt about the need for employees to control their destinies in everything from health care to job security. But, perhaps more than any other leader in Corporate America today, he is also deeply committed to giving them the tools to do this. His eight-year-old Employee Scholar Program gives workers up to three paid hours off a week to study and pays up front for the entire cost of books, tuition, and fees for any education program—except,



CARRIER PLANT
A quality push is paying off in Tyler, Tex.

perhaps, the kind found on matchbook covers or pricey pilot training. The program covers every employee, from the veteran elevator technician in Zimbabwe to a fresh-scrubbed office assistant in Tyler, Tex., with some education benefits even extending to laid-off workers. And, for each degree earned, employees get up to \$10,000 in UTC stock or options.

That commitment has helped a relatively low-profile company draw some of the best in business. What's more, once workers bag the degree, and take home the stock, they tend to stay. Retention among employee scholars is about 20% higher than for regular U.S. workers (UTC doesn't track international rates). Though it's hard to measure, execs also believe that the program has reduced overall turnover by several percentage points—a boon to the bottom line. The program is so generous that it has some benefits experts shaking their heads. "It's doing justice to the world but it's not doing justice to UTC," says E. Faith Ivery, president of consultant Educational Advisory Services. She argues that UTC isn't giving its workers an incentive to spend money wisely and doesn't adequately track the returns. David responds that an educated worker is a better worker.

The cerebral approach

STILL, NOBODY DISPUTES the buzz it generates within UTC. Lance Bartosz, a 30-year-old engineering manager at Hamilton Sundstrand, joined the company after learning about the program from a friend. So far, he has completed an MBA and is now getting a master's degree in engineering. "This made me feel a stronger allegiance to UTC." Ditto for Felice Gray-Kemp, tax manager of Sikorsky's finance unit, who recently got her master of law degree and is contemplating an MBA: "Without knowing me, they were willing to invest in me." Given that roughly 15% of

THE UTC WAY

Here are some key tenets of George David's Japanese-style quality

Educate

Teach line workers common-sense techniques to identify quality problems—and give them the authority to work on the solutions.

Organize

Reconfigure factory floor to make it cleaner, simpler, and more intuitive. Nothing is random; everything has a designated place.

Analyze

Rigorously study the root cause of every defect and complaint. Then, even if it means stopping production, fix the problem once and for all.

Track

Map out every process, make people own it, and reward constant improvements. For every action, ask why and how it could be done better.

Lead

Convert top management into disciples of the process and make proselytizing part of their job. Nonbelievers can head for the exits.

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the company's U.S. workforce is enrolled in the program, it would be hard to know them all.

Such initiatives typify David's quirky and somewhat cerebral approach to running a modern-day conglomerate. Although he seems to have a hard time connecting with the common man—a back slap from David probably means you have food lodged in your throat—he fervently believes that everyone should have the chance to try to better themselves. “America is all about opportunity,” says David, whose Horatio Alger instincts stretch back to his days growing up in Pennsylvania where his father, Charles David, was one of America's first Rhodes Scholars in 1908 and served as a professor at Bryn Mawr College. He was 57 and a well-established historian when his second son, George, was born in 1942. “Without an education, my father would have been a farmer like his father,” he says. That's clearly a disturbing thought for a man who points to the 19th century scholar Sir Richard Francis Burton as his boyhood hero.

Farming, after all, was never to be the fate of George David. After studying physical sciences at Harvard University—an experience that left him feeling largely unmoved because, he says, he was too immature to handle the permissive, impersonal atmosphere—he married his high school sweetheart, Barbara, and pursued an MBA at the University of Virginia's Darden School of Business Administration. “It was like a light switch went on,” says David, who graduated first in his class. He became a management consultant at Boston Consulting Group before going to work for client Otis Elevator as executive assistant to its erudite French-born leader, Hubert Faure, in 1975. As Faure recalls, “he was very remarkable in his analytical mind but, like a lot of bright young men, he was also brash and over-confident.”

David says at Darden, “it was like a light switch went on”

the skills to stay employable—even if they can't guarantee them a job for life.

Instead of being fired when Otis sold out, David was sent to manage the company's operations in then-hyperinflationary South America. He quickly developed a reputation for financial discipline (i.e. cost-cutting), a fixation on details, and intensely demanding leadership. As Carrier President Geraud Darnis explains, “George has always had a way of instilling a sense of humility. He always asks a question you can't answer... and leaves you with a big silence.”

Finding his quality guru

DAVID HONED HIS TASTE for world travel, running both Otis' Latin American and Japanese operations in Sao Paulo and Tokyo before becoming Otis president in 1986. Six years later, he became president and chief operating officer of UTC—an elevator guy in a company where aerospace reigned supreme. He soon learned to navigate the old boys' club and grasp the minutiae of UTC's sophisticated aerospace products. He also closed plants and laid off more than 20,000 workers in his first year. By 1994, he was chief executive and, three years later, added the title of chairman.

One of his first tasks as president was to persuade a diminutive 64-year-old Matsushita Electric Industrial Co. retiree named Yuzuru Ito to move to a Hartford suburb to work on improving the productivity of UTC's businesses. David first encountered Ito in 1989, after he was brought in by the unit's Japanese joint venture partner, Matsushita Industrial, to try and figure out why Otis' fancy new Elevonic 401 elevators were such clunkers. Their callback rates—the number of times per year a building owner has to call mechanics for service—were as high as 40 per unit a year, vs. an average of 0.5 for rival Mitsubishi Electric. When Otis dispatched a team of U.S. engineers to get the machines working, their Japanese partners hauled them into the boardroom to analyze the cause of the problem—even as some elevators were shut down and literally burning. Later, with Ito in charge, the work they did changed the fundamental design of the elevator line worldwide.

David leaned on Ito, first as a consultant and then as a full-time adviser, to make the techniques he used to analyze the elevators adaptable and accessible to every person in the plant. The program evolved and became known as ACE, or

GEORGE DAVID

An intellectual with an eye for detail

BORN Apr. 7, 1942, Bryn Mawr, PA.

UPBRINGING Father, Charles, was a history professor and one of America's first Rhodes Scholars; mother Marion was a library administrator with two graduate degrees.

EDUCATION Harvard BA, 1965; University of Virginia MBA, 1967.

POSITION Chairman and CEO,

United Technologies Corp.

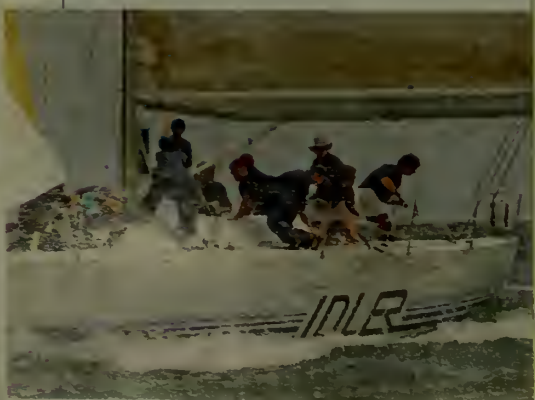
HEROES 19th Century adventurer/scholar Sir Richard Francis Burton, Winston Churchill, and Franklin Delano Roosevelt

INDULGENCES Mogul type toys include a championship yacht. His boat, the Idler, sailed in the U.S. Admiral Cup's team. (David and crew, left.) He collects modern art and owns a cattle ranch in Argentina as well as 20,000 acres of other land.

HOBBIES Sailing, mountain climbing, helicopter skiing; once piloted an F-15 Eagle fighter.

BOOK LIST Eclectic readings include *American Caesar* by William Manchester, *Trading Up* by Sex and the City scribe Candace Bushnell, and *The Devil Wears Prada* by Lauren Weisberger.

FAMILY Divorced with three children; remarried in 2002 to Countess Marie Douglas, a former investment banker and descendant of Grand Duke Ludwig I of Baden.





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Achieving Competitive Excellence. Instead of the complex formulas and training schedules involved with, say, Six Sigma—where the process of becoming a master black belt can generate more sweat and angst than pursuing an actual master's degree—"ACE pilots" are production line workers who learn the quality process in a matter of days. They learn to pinpoint problems ranging from fundamental design flaws such as misplaced bolts to a co-worker's fatigue from staying up with a newborn all night.

One recent result: more logical placement of elevator parts—using special boxes instead of loose bags—that trims \$300 off the cost of each elevator and will lead to \$26.4 million in savings worldwide this year. More important, the factory floor was reconfigured so that the production process was compact—requiring fewer steps, less reaching, and easier access to parts—as well as more intuitive. There are even taped outlines on floors and surfaces, much like the outlines of bodies at crime sites, to show exactly where each widget should go. This is the "5-S" strategy—sort, straighten, standardize, sustain, and shine.

Putting philosophy to work

THANKS TO QUALITY-IMPROVEMENT techniques borrowed from the Japanese, David was off and running in his drive to achieve maximum efficiency. By consolidating thousands of suppliers and streamlining the purchasing process, he trimmed almost \$1 billion in annual costs for general procurement—everything from pens to airline tickets—in the first few years. To keep the ball rolling, in 2001 David put each unit president in charge of streamlining the supply chain for a particular area such as office supplies or travel. But cost-cutting is just one part of the equation. With ACE, says Kent L. Brittan, supply management vice-president, "we can come to market three times faster, with one-third the inventory, and at least 20% less cost."

David was careful to extend the teachings all the way down through the organization. In 1998, he launched an "Ito University" where anyone—not just a bunch of bright young management wannabes—can analyze and share UTC case studies in quality. Lecturers are as likely to be accomplished production line workers as ambitious suit-clad execs. And ACE bulletin boards, documenting every inch of accomplishment on a particular site, became staples in UTC plants.

Of course, a revolution always looks especially vivid to those who are leading it. Down in the trenches, there have been more than a few glitches. Take Carrier's plant in Tyler, Tex. Almost three years ago, David made a visit—because, as he puts it in a true spirit of *noblesse oblige*, "my advisers thought it would be good to go out and comfort our people after September 11." What he encountered was a cluttered and somewhat dingy operation almost choking on its own dust. With the exception of a possible takeout menu or two, there were few signs of Japanese-inspired innovation in evidence.

David isn't a celebrity CEO but he has been richly rewarded

Forget about comforting the stricken. David was livid. When he discovered that senior management at the operation—and their superiors back at headquarters—had essentially pooh-poohed ACE in favor of just churning out more air conditioners and heating units, he fired the plant managers. Heck, he even sent the head of Carrier packing, though he prefers to couch that as an amicable parting. In a visit more than two years later, it was clear that the mes-

sage was starting to sink in. Dusty air and chaotic interiors were vanishing in favor of compact U-shaped assembly lines and brightly lit open spaces. "I could see," David later joked.

A typical result: Square-footage reductions in one area of 50% and 71% more production with 8% fewer employees than on the previous regular conveyor line. David Dickey, the plant's buoyant general manager, also pointed to an almost 20% rise in sales and profits over the past two years. Add to that a dramatic reduction in lost work days, as well as fewer customer complaints and more product innovation. But if Dickey was expecting a high-five from the boss, he didn't get it. After poring through documents and prowling through the plant, the chairman did concede that there had been progress—though he added that the level of product failures in the field was still far too high.

That intense focus on the inside of his company may be part of the reason why David has retained such a low profile. He may not be a celebrity CEO, but he has been richly rewarded for his record in leading UTC. The stock options he got upon being named chief executive gave him an unusually high \$70 million-plus payday last year, thanks to the rise in the stock over his tenure. He's more accustomed to payouts in the single-digit millions, though he did net \$16.8 million this summer when he sold more shares nearing expiration.

Such riches might cause embarrassment to average mortals but not to UTC's philosopher king. The impression that he gives while munching on goat cheese salad in the corporate jet isn't so

much one of entitlement as much as a firm belief that material excess is a fitting reward for those who toil among Corporate America's ruling elite. Yes, he has the \$25 million townhouse in Manhattan and the yacht that competed in the Admiral's Cup. He also divorced his wife of three decades back in 1997. Five years later, he married Countess Marie Douglas, then 30 and a descendant of Grand Duke Ludwig I of Baden. They met when she was an asset manager at Lazard LLC, investing in UTC stock. Together, they share a love of art and have become fixtures on the charity circuit.

What David craves most, perhaps, is to believe that he is making a real difference. Even if creating the planet's most educated workforce or its most successful conglomerate prove to be elusive goals for a man mired in the realities of modern manufacturing, David will continue to try his best. It's what he believes every leader who wants to make history is destined to do. ■



CHARITY CIRCUIT
David and wife, Marie, at a fund-raiser

BusinessWeek online For an interview with United Technologies CEO George David, go to www.businessweek.com/magazine/extra.htm



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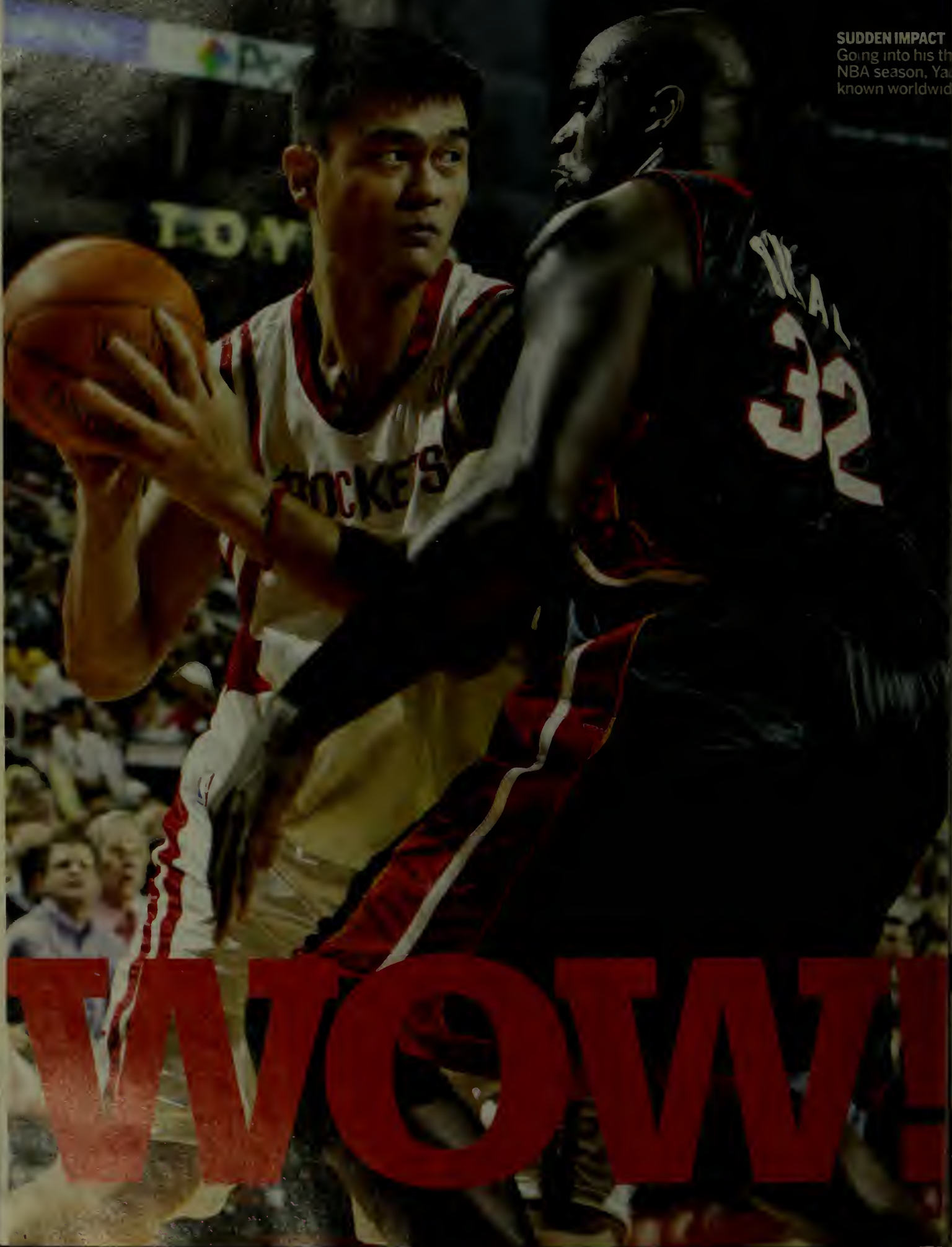


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SUDDEN IMPACT
Going into his th
NBA season, Yao
known worldwid



IN THE BEGINNING WERE PELE AND ALI. THEN MICHAEL AND Tiger and Lance. And now comes Yao. Athletes who by dint of raw talent, force of will, and power of personality transcend national borders and become mythical figures to people all over the planet. Increasingly, these megastars have also become money and marketing machines. But no sports icon in history has the potential of Shanghai-born Yao Ming, the Houston Rockets center and the epicenter of a campaign by American brands to win the hearts, minds, and pocketbooks of 1.3 billion potential consumers in China's red-hot economy.

Just how big is Yao Ming? So big that there's nowhere he can hide. In early September, Yao flew to the Chinese island of Hainan in the South China Sea to celebrate his 24th birthday in the relative quiet and obscurity of a remote beach resort. He brought along some friends and Rockets strength coach Anthony Falsone. In the mornings, Yao and the 5-foot-7-inch Falsone would sneak out to the beach for a three-mile run, hoping to get in their cardio without much notice. But as the 7-ft.-6-in., 310-pound Yao lumbered along the water's edge, crowds of thrilled tourists would begin running beside him—snapping photos and begging for autographs—until there was a horde of smaller beings trampling his footprints in the sand. "It was amazing," Falsone recalls. "There is not a corner of the country where people don't go crazy for Yao."

The scenes of Yao and his giddy herd bring back images of Muhammad Ali being trailed by dozens of schoolkids on his training runs for the "Rumble in the Jungle" prizefight in Zaire 30 years ago. But by then, Ali had long been a global superstar. By contrast, Yao three years ago was a local hotshot in Shanghai and largely unknown beyond China. Now, preparing to enter only his third season in the NBA, he is not just recognized worldwide but could become a real factor in bilateral trade between the U.S. and China.

With his squeaky-clean image (so far) and bashful smile, Yao could be the most effective messenger yet to help American blue-chip brands build business in an economy whose GDP is growing at a robust 9% annual clip. The timing for Yao couldn't be better. The explosion of disposable income in China, its acceptance

into the World Trade Organization, its fastidious preparations for the 2008 Beijing Olympics, all combine to elevate China's most familiar face beyond sports hero. "It usually takes five or six years to build a brand," says Columbia University marketing professor Donald E. Sexton, who has taught in China. "Yao has obviously accelerated that for himself and can do that for others in a country that is just beginning to understand brands." Adds Jeffrey Swystun, global director of branding consultancy Interbrand Corp.: "If you are teamed up with Yao, you have an instant leg up in a marketplace of a billion people."

"TREMENDOUS GLOBAL ASSET"

YAO'S STAR POWER WILL NEVER be more evident than on Oct. 14 and 17, when he returns to China to play for the Rockets in two NBA preseason games against the Sacramento Kings in Shanghai and Beijing. Top U.S. marketing executives will be on the ground, following Yao-mania and using the so-called China Games to wheel and deal new agreements and gain an important first advantage to exploit the 2008 Summer Olympics.

More than 200 million Chinese are expected to watch the NBA's pre-season games on TV—70% of the entire U.S. population. "Nobody was more of a global icon than Michael Jordan," says NBA Commissioner David Stern. "But Yao is different.... He is a symbol of this Chinese renaissance and their determination to compete on a world stage."

In the two years that he has been their pitchman, Yao is already helping McDonald's sell more Big Macs, Pepsi more soda, and Reebok more basketball shoes in China. McDonald's will nearly double its outlets there to 1,000 by the start of the 2008 Olympics, says Dean Barrett, senior vice-president for global marketing. "[Yao] is a tremendous global asset for us."

Despite this frenzy, Yao has turned down dozens of offers from major companies. Reebok International CEO Paul B. Fireman says that Yao's handlers have done a good job of "not rushing [him] out to every company, not prostituting him." So don't expect to see the big guy sporting a Stetson and pushing cars for a dealership in Sugarland, Tex. His agents, an eclectic bunch called Team Yao, are mostly sticking to what may be a

For U.S. brands selling in China, NBA sensation
Yao Ming is one hot ticket **BY TOM LOWRY**

YAO!

first in the world of sports biz—a confidential, five-year marketing plan developed with the help of University of Chicago MBA students. Because of his surging popularity, Yao is ahead of schedule, and Team Yao's fear is that he will be overexposed.

So far Team Yao's planning and patience seems to be paying off, however. Yao's four-year contract with the Rockets is worth \$18 million, and he earns an estimated \$15 million a year in longer-term deals with top-tier brands Pepsi, Reebok, Gatorade, and McDonald's. As his agents strike more deals—and they say they will pick up the pace in the runup to the 2008 Olympics—some executives believe Yao has the potential to gross \$300 million in his first 10 years in the league.

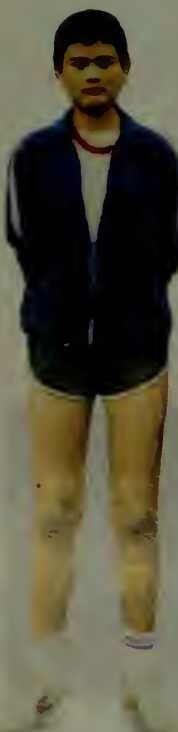
GIANT WITH A SENSE OF HUMOR

THE RISK FOR THE MARKETERS that have agreed to the multi-year deals Team Yao demands is that Yao never fully develops on the court or that he goes down with an injury. He was selected as the No. 1 pick in the NBA's 2002 draft and has been voted an All-Star in his first two seasons. In terms of his athletic performance, however, Yao is not yet anywhere near Michael Jordan or Ali at their peaks. So Yao is trying to keep his eye on the ball. "What is most important is basketball and my rest," he says.

Staying focused could be hard, though, because Brand Yao is everywhere this fall. In addition to the NBA games in China, a new documentary, called *The Year of the Yao*, debuted in September at the Toronto International Film Festival. *Yao: A Life in Two Worlds*, an autobiography co-written with ESPN: *The Magazine* writer Ric Bucher, was published in early October. And the NBA games in Beijing will be the first time two U.S. pro teams have played each other in mainland China. Needless to say, the Chinese are psyched. Says 34-year-old architect Su Jin-song, a Yao fan from Hangzhou: "His excellent performances in the NBA represent the tough spirit of China's young generation. Yao Ming has brought honor to his homeland."

Yao has endeared himself to America, too, ever since starring in a self-deprecating way in two memorable TV commercials: one for the Apple G4 Powerbook with the 2-ft.-8-in. actor Verne Troyer (a.k.a. Mini-Me of *Austin Powers* fame); the other for Visa, which featured the amusing "Yo-Yao" checkout-counter exchange and was first aired before tens of millions of viewers during the 2003 Super Bowl. The ads broke down the mystery of this intimidating giant by showing he can laugh at himself.

The lucky handful of big companies with Yao deals in place say they are already seeing a difference. McDonald's has even gone so far as to appoint him its "first ever worldwide brand ambassador." With Yao as its spokesman, Reebok's Fireman says he could see capturing more than 25% of an estimated \$1 billion sneaker business in China by 2008. The company currently does about \$30 million in sales there.



BIO

YAO MING

With parents who both played for China, a basketball career was no surprise

JOB Center, Houston Rockets.

BORN Sept. 12, 1980, Shanghai.

EDUCATION Shanghai Physical & Sport Technical Education Institute; Shanghai Foreign Language Institute (as a schoolboy, left).

DIMENSIONS 7'6", 310 pounds, size 18 shoe.

PepsiCo Inc., which has an endorsement deal with Yao in China, reports sales are up almost 30% in the past year. Richard Lee, Pepsi's Shanghai-based senior vice-president for marketing in China, says he's not sure he can attribute all of that to Yao. But he points out that Yao's persona is in keeping with Pepsi's slogan "Dare for More." And despite his nice-guy image, Yao is no pushover. When Pepsi competitor Coca-Cola Co., a sponsor of the Chinese national basketball team, began using his image on its bottles in China, Yao sued. Coke contended that the government had the rights to his image. A judge disagreed, and Yao won his case.

Many companies that have used Yao to pitch their goods would love to strengthen their ties to him. Walt Disney Co. will show the China exhibition games in the U.S. on its ESPN channel, and its Miramax Books Div. is publishing Yao's life story. But Disney President Robert A. Iger says the entertainment giant wants a broader relationship with Yao.

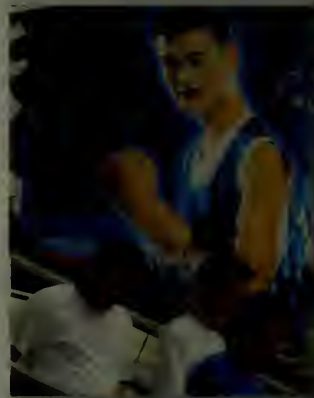
China is "extremely important" to Disney, says Iger, and Yao "could fit neatly into our approach to building our brands there." Iger envisions Yao helping Disney to open its new theme park in Hong Kong sometime in 2005 or 2006. He could also see Yao introducing the Chinese version of *The Wonderful World of Disney* TV show, much the same way Walt Disney and later CEO Michael D. Eisner did.

What's the one business with which Yao would really like to partner? Video games, he says. He is an almost obsessive player. But Team Yao is waiting for the right deal, sources say, from industry leader Electronic Arts Inc. So it may be no coincidence that EA, based in Redwood City, Calif., is planning to build a video-game studio in China. Can a Yao deal be that far off?

At home, Yao has done deals with China Unicom and Internet outfit SOHU. In 2003, SOHU linked up with one of Yao's U.S. corporate partners, trading card company Upper Deck Co., to

THE YAO EFFECT

The Houston Rocket All-Star Center is an economic tour de force helping businesses in America, China, and elsewhere. Among them, getting a boost:



PEPSICO

He's a spokesman for the soft drink and snack maker in China. Long the No. 2 behind Coke in China, Pepsi is gobbling up share. Sales rose nearly 30% there last year.



« McDONALD'S

Yao pitches for the fast-food chain and could replace old Ronald McDonald as its global symbol. It has 650 outlets in China but plans to have 1,000 stores by 2008. The 100 new restaurants it plans to open there next year will be the most for any country.

« GATORADE

Yao is a spokesman for this Co unit in the U.S. An ad featuring Yao, Derek Jeter, and Peyton Manning first seen last year. Yao has pitched the highest ever in popularity among consumers in the company's history. Gatorade is planning a launch in China.



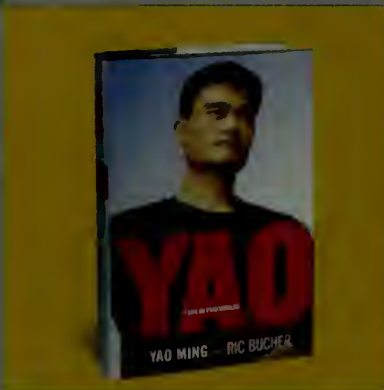
« WALT DISNEY

The entertainment giant, through its ESPN unit, will broadcast the Rockets-Sacramento exhibition games in China on Oct. 14 and 17, and its Miramax Books division just published Yao's autobiography, *Yao: A Life in Two Worlds*. Could a more sweeping sponsorship deal be far off?



« REEBOK

Yao has a sponsorship deal with the footwear and apparel outfit, which projects that its sales in mainland China will grow from \$30 million this year to about \$300 million by the 2008 Beijing Olympics—more than 25% of China's estimated sneaker market.



« HOUSTON ROCKETS

Revenue from sponsors has risen 300% since Yao came to town, and the number of companies partnering with the Rockets has more than doubled to an estimated 40 this year. Execs are predicting record season-ticket sales at the 18,500 seat Toyota Center.

to build and promote the English and Chinese Yao Ming Web sites in an exclusive two-year deal. Marketers say that Yao could prove to be just as invaluable to Chinese companies looking to go global as to U.S. companies seeking business in the Middle Kingdom. "His real power as a marketer, I believe, is outside China," says Terry Rhoads, co-founder of consultants Zou Marketing in China and a former Nike Inc. exec who signed Yao to his first sneaker deal (now expired) when he was playing for the Shanghai Sharks.

Managing this booming enterprise called Yao is a team that

by any measure is unique in the fast-paced, hard-nosed business of sports representation. It includes veteran NBA agent Bill A. Duffy, indie movie marketer-turned-agent Bill Sanders, University of Chicago economics professor John Huizinga, and Chinese-born entrepreneur M. Erik Zhang.

Everyone's role in Team Yao is well defined: Duffy, president of BDA Sports Management, oversees relations with the NBA. Sanders, also of BDA, does most of the U.S. sponsorship agreements. Huizinga negotiates the Rockets contract, and Zhang, who is married to Yao's cousin, does the deals in China and

am in Shanghai as well. After he retired, he ship inspector at Shanghai harbor until as drafted by the Rockets. His parents now half the year in Houston. Yao's girlfriend, s 6'3" and plays for the Shanghai Octopus n's team and the national team. She wears like Yao.

WHAT HE DOES FOR FUN WHEN HE'S NOT FIGHTING IT OUT IN THE PAINT Video games; spending time with friends. Chatting online with his fans back home in China.

FAVORITE NBA PLAYER Retired Trailblazers' 7'3" center Arvydas Sabonis, a Lithuanian native.

ON WRITING HIS AUTOBIOGRAPHY AT 24 "It has been a whirlwind for me!"

FAVORITE AMERICAN FOOD Steak

ON CHINESE FOOD IN HOUSTON "Definitely, there are a couple good restaurants, but my Mom's [cooking] is still my favorite."

serves as part-time counselor to his friend.

How Team Yao came together and developed its five-year marketing plan is a story in itself. It starts with Zhang, who was getting his MBA at the University of Chicago Graduate School of Business. He happened to meet Huizinga, a basketball fanatic and then the B-school's dean of faculty, at an NBA rookie tryout in Chicago in the spring of 2002. Zhang asked for Huizinga's advice, and the professor met with Yao over dinner the next day. Soon, Huizinga was a full-time member of Team Yao. After Yao's selection in the NBA draft, Huizinga suggested that Chicago B-school prof Jonathan K. Frenzen's new-product workshop class might help develop a marketing plan. In the fall of 2002, eight students began working on Yao The Product, conducting focus groups, marketing polls, and dozens of street interviews in China. Team Yao paid more than \$60,000 to cover expenses.

"We discovered that the world of possibilities for Yao was vast," says Frenzen, whose students have helped the likes of United Airlines, Citibank, and Honeywell develop marketing plans for products—but never for a person. The class's 500-page report remains under wraps, and the students had to sign confidentiality agreements. Even Rockets marketing execs could only read the report with someone from Team Yao present.

The guiding principle of the report was patience, says one of the students who helped put it together, Aaron Abraham, 30, now a project manager at Nike. "We knew he had the potential to be a huge gateway to China, and we wanted him to be true to the country's old values but also reflect the newer generation." He says there were no specific financial targets. "It was more strategic," says Abraham. "We were interested in protecting him as a brand." Abraham, citing his confidentiality agreement, declined to provide details from the report.

Team Yao has followed the report's game plan closely but not exclusively, says Sanders. He sees a Yao wave building that will

RED STARS RISING

U.S. companies are already scouting China for the next marketing marvel. Here are three of the top candidates:



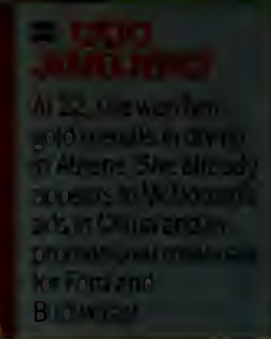
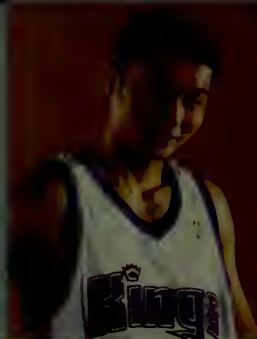
LIU WEI

Yao's 6'3" teammate on the Shanghai Sharks and Chinese national team could become, at 24, the first Chinese guard in the NBA, with Sacramento, and the fourth Chinese player overall.



LIU XIANG

An Athens gold medalist in the 110-meter hurdles, Liu has a colorful personality and an actor's good looks. No wonder Liu, 28, already has deals with Coke and Nike.



Not exactly the bling-bling talk of a pro jock looking to get his mansion featured on the next episode of *MTV Cribs*. Offers Yao co-author Bucher: "Yao is constantly deflecting the trappings of fame that people try to put upon him."

Yao lives comfortably in a gated community in Houston. His parents—he is an only child—stay with him during the season. He drives a Toyota truck and a custom-fitted BMW 745 (no backseat). His English has improved, but he still travels with an interpreter, Colin Pine, a 30-year-old former State Dept. employee. When Yao doesn't understand something, he will give Pine, always on his right, a gentle nudge.

In order to play in the U.S., Yao first had to reach a financial agreement with China. It has never been revealed how much of his earnings go back to the government in Beijing through payments to his old team, the Shanghai Sharks, and the Chinese Basketball Assn. But sources say it is close to a third of his salary. It could ultimately be more, these sources add, depending on how long he stays in the league and on his success. Team Yao declined to comment.

With the start of the regular NBA season only weeks away, Yao is trying to put aside Yao Inc. to concentrate on hoops. Above all, Yao knows he needs to perform better. So do his bosses. "He has not yet achieved great things in the NBA," says Rockets President and CEO George N. Postolos.

Last year, the Rockets made the playoffs but lost 4-1

to the Los Angeles Lakers. Yao, with an average 17.5 points and nine rebounds per game in the 2003-04 season, has many miles on the court ahead of him before he can hope to match the record of Jordan, who helped deliver six championships to Chicago. Call him a global brand ambassador or marketing marvel, but he'll still need to add "champion" to his titles. Sooner or later, even the biggest man in China must win big to stay big. ■

—With Dexter Roberts in Beijing

ABOUT A THIRD OF YAO'S SALARY GOES TO BEIJING

crest at the 2008 Olympics. "The finish line is 2008. Beijing is the big day, the pinnacle of Yao's earning power," says Sanders. "The world will be watching."

Yao is uncomfortable talking about the business side of his life. In his book, he offers up these thoughts on money: "I sweat for every paycheck. If that makes me the best-known capitalist in China today, I don't have a problem with that. ... I still feel as though whatever money I have in my pocket—the money I can see and use—is what I have. And it's definitely all I need. ... No one making millions can say he really needs the money to live. That's not what it means. It is a way to measure your worth in your job. If my next contract with the Rockets is for more money... it's because I'm worth more to them."

BusinessWeek online For an interview with NBA Commissioner David Stern and for more on Team Yao, go to www.businessweek.com/magazine/extra.htm

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Pumped-Up Pension Plays?

Regulators are investigating how some companies tinker with retiree accounting

TELECOM GIANT SBC Communications Inc. last year reported a stunning \$2.2 billion plunge in operating income, and the company's explanation probably seemed arcane to many investors. SBC's number-crunchers, the company said, had lowered the expected return on retirement funds by a mere percentage point. Likewise, they raised their assumption of health-care cost inflation by a single point. And they shaved their estimate of future interest rates by just 0.75 percentage points. Add it all up and it translated into a big earnings hit: \$693 million sliced off the bottom line.

At the same time, many other U.S. companies were making similar adjustments. SBC was among hundreds of companies that last year updated key assumptions in their accounting for post-retirement benefits to bring estimates more into line with real-world trends. "I'm very confident that our assumptions are appropriate," says John Stephens, SBC's controller.

Such changes, and the impact they can have on profits, have caught the eye of the Securities & Exchange Commission.

BusinessWeek has learned that the agency's Enforcement Division is conducting an investigation: It has identified a few dozen companies whose assumptions seem aggressive and whose pension plans are big enough that changes in the estimates could have a significant impact on the bottom line. In early October it sent letters to half a dozen of them, requesting documents, including e-mails between those who set assumptions, explaining how they arrived at their estimates. SEC Enforcement Director Stephen M. Cutler says his department is "looking to see whether managers are adjusting their assumptions with an eye to enhancing the earnings and balance-sheet numbers investors care about. That could be fraud."

"EASY WAY"

THE SEC, WHICH declined to name the companies, says it has no evidence yet of wrongdoing. Pension accounting is one of many areas where executives have to make estimates (BW—Oct. 4). Differences in the investment mix and the age of workers and retirees could explain why some assumptions vary widely from the average.

Another SEC unit, the Corporation Fi-

nance Division, has been making general warnings for some time, telling companies not to use overly rosy pension assumptions. Such estimates matter because in pension accounting, companies report their projected earnings for the plan, not actual returns. If the assumed return on

The SEC Cracks Down on Rosy Assumptions

The SEC is probing possible abuse of pension and retiree health-care accounting. Regulators are looking at:

Data.

ASSUMED RATES OF RETURN

Companies have an incentive to overestimate how much their pension investments will make. The reason: If pension gains exceed costs, the excess goes into earnings. The SEC frowns on estimates over 9%. Last year 26% of S&P 500 were at 9% or higher.

DISCOUNT RATES

To figure the future cost of pensions, companies must apply a discount rate. The higher the rate, the lower their potential obligations and the plan's yearly cost. The average discount rate for S&P 500 companies was 6.25%; some 140 companies used higher rates.

HEALTH-CARE INFLATION RATES

In figuring the future cost of medical benefits for retirees some companies underestimate health-care inflation. That understates expenses. Although medical costs jumped 15.2% in 2002, at least 68 large companies assumed less than 9% health care inflation for 2003.



make a big difference. A study published by the National Bureau of Economic Research in May by accounting professors Daniel B. Bergstresser and Mihir A. Desai of Harvard Business School and Joshua D. Rauh of the University of Chicago Graduate School of Business found that nearly 5% of IBM's pretax income in 2000 and 2001 resulted from an increase in the assumed rate of return from 9.5% to 10% in 2000. IBM adjusted the rate, which is meant to be a long-term projection, four times between 1991-2002. IBM says the company's decision to raise the assumed rate of return in 2000 was consistent with actual returns ranging from 14% to 21% over five previous years.

The study also offers support for speculation that some executives may deliberately monkey with pension assumptions for corporate and even personal gain. The trio analyzed accounting for 3,247 pension plans from 1991-2002 and found that companies tended to hike pension return estimates the year before making an acquisition or before a CEO exercises stock options. "If you want an easy way to manufacture earnings, this is as good as it gets," says Desai.

In December, 2002, the SEC warned companies that it might challenge rate-of-return assumptions above 9%, based on historical returns in equity and bond markets. Average return assumptions fell to around 8.38% in 2003, from 8.82% the year before. Still, 26% of the 355 companies in the S&P 500 that offer

defined benefit pension plans estimated returns of 9% or higher in 2003, according to a UBS Investment Research study. Among those using assumptions above 9%: Darden Restaurants, owner of the Red Lobster, Olive Garden, and other eateries. William R. White, vice-president and treasurer of Orlando-based Dard-

en, says the company's 10.4% assumed return was in line with actual returns of 10.5% over the 10 years ending May, 2004. Still, Darden has lowered the rate to 9%.

Many experts think even 9% is tough to justify. Given long-term stock and bond returns, an 8.5% rate is more reasonable for a typical portfolio with 65% equities

and 35% bonds, CSFB analyst David Zion argues. Higher-than-average return assumptions don't necessarily signal accounting mischief. Plans tilting more toward equity investments tend to achieve higher returns. And multinationals with big overseas workforces may invest pension money in markets with higher returns and interest rates than in the U.S.

A BLIND EYE

COMPANIES HAVE LESS discretion over another factor, the discount rate, used to calculate future pension obligations in today's dollars. The higher the rate, the lower the pension expense. The discount rate is supposed to hew closely to high-quality corporate bond yields. The average discount rate for S&P 500 companies was 6.25% in 2003, down from 6.69% in 2002, according to UBS Research. A company with an older workforce and many retirees will tend to use a lower rate than one with younger workers and fewer retirees because it must pay benefits sooner. A few of the biggest companies, however, use rates of 7% or higher.

Accounting for retiree health-care plans is just as byzantine. Some 328 of S&P 500 companies pay health-care costs for retirees. Accounting rules require companies to estimate future health-care inflation. Lowballing the trend in health-care costs minimizes the long-term benefit liability and understates expenses.

Health-care costs have been growing at a double-digit clip, hitting 14.7% in 2003, according to benefits consultant Hewitt Associates Inc. But some companies have stuck to single-digit assumptions. Experts say such estimates are overly optimistic and suspect that auditors too often turn a blind eye. "Companies aren't willing to change these projections substantially because they don't want to create any earnings volatility and auditors aren't challenging them," says Michael Lofing, senior research analyst at Glass, Lewis & Co., a proxy advice and forensic accounting firm based in San Francisco.

Accounting experts have been lobbying for tighter rules to limit the discretion companies have over pension assumptions. The Financial Accounting Standards Board, the Norwalk (Conn.)-based private group that the SEC relies on to set accounting rules, agrees. But it could be years before the FASB takes final action. For now, the SEC's sweep serves as a warning to executives not to take advantage of the wiggle room. ■

—By Amy Borrus and Paula Dwyer in Washington, with Michael Arndt in Chicago and David Welch in Detroit

Small shifts in projected returns can make a big difference in earnings

pension investments exceeds the pension cost, companies can count the surplus in their earnings even when real returns stink.

Boeing Co., for instance, lost \$3.3 billion on pension investments in 2002, but reported a \$404 million pension gain based on its assumed 9% rate of return. That was 82% of the aerospace company's net income for the year. (Boeing notes that when assumed returns fall below actual costs, the company must report a loss in earnings, as it will have to do for 2004.) That's not an isolated case. UBS Investment Research figures about \$2 of the \$55 earnings per share for companies in the S&P 500 index in 2003 came from aggressive pension return assumptions.

Small shifts in projected returns can

Citi's Bob Rubin Is Back in the Game

Politics, that is. He has Kerry's ear, and that improves the candidate's credibility

ON OCT. 12, THE EVE OF the Presidential debate focusing on the economy and other domestic issues, Robert E. Rubin, who serves as John Kerry's top economic adviser, says most folks have no clue who he is. "They don't remember me. Do you think they do?" he ponders in his self-effacing way.

Financial types certainly know who Rubin is. And given the number of TV appearances he has made lately—four in the last two weeks—the average guy on the street may now recognize him, too. Rubin, a Citigroup director and former Treasury Secretary under Bill Clinton, has been out promoting the paperback debut of his book, *In an Uncertain World*. But he's using the opportunity to talk up the Democratic Presidential nominee.

Rubin's name is continually invoked on the campaign trail. During the Oct. 8 debate, even President George W. Bush mentioned Rubin when he poooh-pooohed Kerry's plan to keep jobs from going overseas: "Robert Rubin looked at his plan and said it won't work." Says Rubin: "Bush misunderstood me. Kerry has his head on very straight in terms of economic policies."

Whatever the case, having Rubin at Kerry's side is a good strategy, say experts. Says Greg Valiere, chief strategist at Charles Schwab Corp.'s non-partisan Washington Research Group, "Rubin absolutely helps the Kerry ticket. He reminds people of the mid-to-late 1990s, when investors did well." Indeed, the "Bring back Bob" chants seem to be getting louder, even from some Republi-

cans. Says Peter G. Peterson, co-founder of the Blackstone Group and a longtime Republican: "He engineered one of the most responsible fiscal periods in recent American history."

Rubin, 66, is not officially part of the Kerry campaign. But that doesn't mean he's averse to Kerry-related close-ups. At the Democratic National Convention in July he sat next to Teresa Heinz Kerry during her husband's speech. On Sept. 15, he was with Kerry at the Detroit Economic Club while the candidate slammed Bush's policies and spelled out his own. Says Gene B. Sperling, director of the National Economic Council under Clinton and part of Kerry's election team: "When Kerry has to make major speeches or policy decisions, the senator almost always asks that Bob be in the room

or on the phone." Rubin says he was holed up with Kerry for two days this summer and has had countless phone chats with him since. "He just called me this weekend," says Rubin.

Kerry and Rubin work well together, but don't agree on everything. "Kerry is more committed to middle-class tax cuts than Bob," says a campaign source. "Bob

would rather take the deficit reduction."

No doubt, Rubin is in his element when talking about reducing the annual budget deficit, now at around \$415 billion. He argues that it will lead to high interest rates, which will curb investor enthusiasm and put the brakes on the recovery. And to put it bluntly, Rubin thinks Bush's tax cuts, especially those for the wealthiest Americans, stink.

CITI SCANDALS

RUBIN HAS HIS CRITICS. "You need tax cuts to stimulate investment and jobs," says Stephen Moore, head of the Washington-based antitax Club for Growth. He adds that "getting rid of deficits doesn't make interest rates go down." Others say

Rubin closed the budget gap mainly because of the tech boom, when high productivity and a bull market powered the economy.

If he helps Kerry win the election, Rubin is likely to go to Washington as well. "I think he's bored with what he's doing at Citigroup," says a close business associate involved in the Kerry campaign. "My sense is that he really wants to be the next Fed chairman." Rubin denies this: "My mind isn't there right now."

What about Rubin's record at Citigroup, which has seen its share of scandals? Critics are dismayed that he emerged unscathed. A year after he joined in '99, Rubin made a call to the Treasury Dept. to intervene on behalf of Enron Corp. Soon after, Citi was hit hard by the analyst scandal and had to split its investment banking and research arms. And Japanese regulators recently ordered the bank to shut its private-banking operation because of legal violations. Says Rubin: "Citigroup has a great management team. It will work these things out."

DEFICIT HAWK
Rubin favors rescinding most Bush tax cuts

ter, Citi was hit hard by the analyst scandal and had to split its investment banking and research arms. And Japanese regulators recently ordered the bank to shut its private-banking operation because of legal violations. Says Rubin: "Citigroup has a great management team. It will work these things out."

Rubin says he has always had a hankering for public life. If Kerry is elected, folks will likely once again be reminded just who Bob Rubin is. ■

—By Marcia Vickers in New York



When Kerry makes a big economic speech, he often consults with Rubin



9-11am:

Have brunch with editor for upcoming article on next year's Spring/Summer collection

1pm-3pm:

Drop by designers luncheon to discuss tomorrow's charity fashion show

4pm-6pm:

Prepare a surprise candlelight dinner for two to celebrate husband's birthday

or

10-11pm: Watch 2005 Paris Summer Collection on TV in (location for next week's article)

Life's



UNFAZED
Lord would still prefer a Bush victory

Taking the Politics Out of Sallie Mae

Diversification has made the student loan king less vulnerable to ideological shifts

IT'S NO SECRET WHICH WAY INVESTORS in student loan titan Sallie Mae want the election to go. The company's stock often slips when Senator John F. Kerry, who pledges to overhaul student loan financing, gains momentum. It usually climbs as George W. Bush's star rises. So far this year, Sallie's price has edged up about \$7, to \$45, after doubling in Bush's first three years in office. "People are treating this as a political stock," says Friedman, Billings, Ramsey & Co. analyst Matthew J. Snowling. "It's a proxy for the election."

Politics have always played a major role in Sallie's fortunes, and that won't change after the long process of privatizing the company is finished in January. Washington created Sallie in 1972 to buy government-backed college loans from banks, a Fannie Mae for the campus set. More recently, it began making student loans itself. And as it has become more market-oriented, Sallie has ventured even farther afield of its original mission, offering credit cards to car-loan refinancing.

Albert L. Lord, chief executive of the Reston (Va.) lender, isn't fazed by all the politics. A Republican who has raised money for Bush, he contends that a Kerry

victory would actually help Sallie. True, the Democrat wants to auction the right to issue federally backed student loans, which could drive down margins. Kerry also rails against what he calls lenders' "excess profits"; he's eager to bar them from pocketing interest beyond the current 3.4% guaranteed rate. But these

Why Sallie Votes For the **Status Quo**

College-loan kingpin Sallie Mae might face a tougher climate if John Kerry is elected

A KERRY WHITE HOUSE COULD

- Favor direct government student loans instead of those issued by Sallie Mae
- Curb what he calls the industry's "excess profits"
- Boost the numbers of outright grants to students

A SECOND BUSH ADMINISTRATION COULD

- Let the government's direct-loan program wither
- Stick to a "hands-off" policy that allows Sallie to build its loan business as much as the market allows
- Lift the cap on how much a student can borrow with a government guarantee

changes, Lord says, "would frighten away a lot of our competitors."

Who wins may matter less now that the company is more diversified, Lord argues. The transformation started in 1997, when he mounted a proxy fight to take charge of the company. He began deploying Sallie's secret weapon—the data it collects from student borrowers. Lord has signed deals with MBNA, GEICO, the Experian credit reporting agency, and others to pitch Sallie's 7 million borrowers everything from car insurance to Internet access. Including private, nonguaranteed student loans, the new businesses will account for 30% of revenue this year. "It has evolved much more successfully than I had expected," says Lord, a 59-year-old former Philadelphia banker.

Indeed, Sallie is becoming an extremely profitable financial player. Analyst Snowling figures that many of the new businesses boast huge profit margins, well north of 20% on debt collection, for instance. In 1997, Sallie earned \$308 million on revenue of about \$1 billion. This year, Snowling figures Sallie will earn \$830 million on \$2.26 billion in revenue.

BELTWAY VULNERABILITY

LORD HAS MADE MISTAKES during Sallie's march to the private sector. He lost \$20 million on a software firm and did business with dubious computer training schools. He also ran afoul of some members of Congress by withholding loan repayment information from most credit agencies. The move stymied competitors, but also hurt students trying to build credit records. Sallie officials are working on ways to report the information.

No matter how much its new business lines grow, Sallie will remain vulnerable to Beltway policy shifts. Its core business involves some \$87 billion in government-guaranteed student loans. Far less—just \$11.6 billion—of Sallie's assets are in private student loans, which are more lucrative because they carry higher interest rates.

Ultimately, Lord figures that Congress won't harm student borrowers, who depend on the likes of Sallie. To keep congressional critics at bay, Sallie's \$770,000 political action committee has given more this year to Democrats dealing with education policy than to Republicans, though Lord expects the balance to tilt toward the GOP by Election Day. Either way, Lord hopes to be celebrating a Bush win.

—By Joseph Weber in Chicago

(4:30pm: It looks like the 'Earthy Green look' will be back, as you start making the lobster salad)

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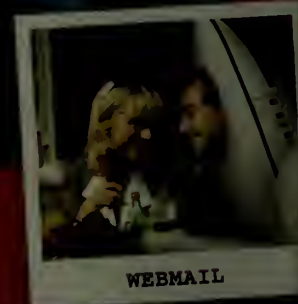
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IMPORTANT PUBLIC HEALTH INFORMATION REGARDING CLEFT LIP & PALATE

What Is Cleft Lip And Cleft Palate?

A cleft is a separation in a body structure. Clefts that occur in the oral-facial region often involve the lip, the roof of the mouth (hard palate) or the soft tissue in the back of the mouth (soft palate). Two major types of oral-facial clefts are cleft lip/palate and isolated cleft palate. Babies with cleft lip/palate have a cleft lip which usually is accompanied by cleft palate. In isolated cleft palate, the cleft palate occurs by itself, without cleft lip or other malformations. The lip or the lip and palate together fail to close in approximately 1 in every 1,000 babies born. Cleft palate occurs alone less often, appearing in approximately 1 in 2,000 babies.

What Causes Cleft Lip/Palate? The causes of cleft lip/palate are not well understood. Studies suggest that a number of genes, as well as environmental factors, such as drugs (including several different antiseizure drugs), infections, maternal illnesses, maternal smoking and alcohol use and, possibly, deficiency of the B vitamin folic acid may be involved.

Can Oral-Facial Clefts Be

Prevented? While little is known about how to prevent oral-facial clefts, studies suggest that taking multivitamins containing folic acid before conception and during the first two months of pregnancy may help prevent cleft lip/palate and isolated cleft palate. Other studies have shown that fetuses with certain predisposing genes may be at increased risk for isolated cleft palate if their mothers smoke.

Women who are planning pregnancy or who are pregnant should avoid alcohol, which also can cause a number of mental and physical birth defects. Because some types of medications (such as some drugs used to treat epilepsy) have been linked to increased risk of cleft lip/palate, women who take medications for chronic illnesses should check with their doctors before they become pregnant. (They should not, however, discontinue their medication without discussion with their physician.). All pregnant women should use only medications prescribed by a physician who knows of the pregnancy, and get early and regular prenatal care, beginning with a pre-pregnancy visit. Families with a history of cleft lip/palate, isolated cleft palate, or any other condition of which clefting is a part, may wish to discuss the chances of recurrence with a genetic counselor.

Can Oral-Facial Clefts Be Repaired?

Surgery often is used to correct cleft lip/palate and isolated cleft palate. The timing and type of surgery depend upon a number of factors, including the preference of the surgeon, the health of the baby and the nature of the cleft.

Other Sources Of Information On Cleft Lip And Palate. In addition to this valuable information we have tens of thousands of pages of information regarding cleft-related medical journal content, news articles and stories, important cleft resources for patients, their families, and cleft medical professionals, medical students and leading cleft organizations around the world. For more information on cleft lip and palate please visit the world's largest cleft website:

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COMMENTARY

BY AARON BERNSTEIN

Are We Better Off Than 4 Years Ago?

Overall, wages went up—but job losses have hit family incomes hard

RONALD REAGAN STRUCK A nerve during his 1980 Presidential campaign against Jimmy Carter when he asked Americans: “Are you better off now than you were four years ago?” The economy had gone through a recession earlier that year, so the answer for many was a resounding no. Ask the same question about President Bush’s tenure

day, though, and the response isn’t so clear-cut.

Families have made some real gains. Surprisingly, average wages managed to outpace inflation right through the downturn of 2001 and are about 2% higher today, after inflation adjustments, than they were before Bush took office. His mammoth tax cuts, while top-heavy, did put money into average households’ pockets. And low interest rates have propelled home ownership to record heights.

But at the same time, the data show an apparent contradiction: That despite the wage gains of the past four years, family incomes have nonetheless declined after inflation. Why? Because employment is down and so are hours worked, outweighing the pay gains. Even the affluent haven’t been spared. To compensate, Americans have refinanced mortgages, piling on the debt and lowering their average net worth. Soaring medical costs, which employers have been shifting onto workers, have further depleted the family purse. Those at the bottom of the ladder have fared the worst: Poverty climbed steadily throughout the Bush years.

Add it all up, and the average U.S. household is somewhat worse off today than in 2000—several years of gain followed by not enough gain to make up the difference. “Americans barely held their own in the past four

years, with bottom-half families clearly losing ground and some top-half ones maybe a little better off, mostly from the tax cuts,” says Economy.com Inc. Chief Economist Mark M. Zandi.

The hot-and-cold experience of most families may explain why Democratic Presidential candidate Senator John Kerry has not been able to gain more traction on the issue. Certainly, he and running mate Senator John Edwards have tried, attacking Bush on sluggish job growth, the middle-class squeeze, and two Americas, rich and poor. But the fact that real wages have largely held up, as have households’ ability to maintain their purchasing power, seems to have offset the wider backlash that Kerry might expect after four years of sagging family incomes. “Americans have been borrowing to sustain their consumption, which means they’re optimistic about the future,” says Kevin A. Hassett, the director of economic policy at the American Enterprise Institute (AEI), a conservative Washington think tank.

Perhaps the most unusual aspect of the Bush economy is the



THE MARCINS
They can't afford to put him on her medical plan

growth of wages through the recession even as the recovery came up short on job creation. Although unemployment rose and then slowly declined, wages beat inflation for the first three years of Bush's term, according to an analysis of Census data by the Economic Policy Institute (EPI), a liberal group in Washington (charts). Only this year did real hourly pay fall a bit.

Tax cuts, meanwhile, benefited everyone, though most of the money went to the upper brackets. The average taxpayer's total annual income boost: \$647 from three major tax reductions, according to an analysis by Washington's Tax Policy Center, a joint venture of the Brookings Institution and the Urban Institute.

Unfortunately, the jobless recovery is still causing pain. Employment has climbed in the past 13 months but remains at about 1 million jobs less than before the downturn began more than three years ago, according to the Bureau of Labor Statistics. That's by far the worst showing in decades. Not only are 1 million fewer people earning paychecks than in 2000, but several million more have withdrawn from the labor market or didn't join it in the first place, according to BLS data showing stagnation in the growth of employment relative to population. In addition, a decline in work hours has lowered the pay of many of those who have held on to their jobs. The average family put in 2,965 hours of work last year, a

5.5% decline from 2000, the EPI found.

The punishing combo of fewer jobs plus fewer hours worked has left family incomes in the hole. The average household earned \$43,588 last year, 3.4% less than in 2000, after adjusting for inflation, according to Census Bureau data. That's a decline of about \$1,500 a year, which \$647 in tax cuts couldn't fully offset.

Further biting into the family pocket-book: more health insurance cost shifting from employers onto workers. Employees' share of annual medical costs are up to 32% this year, vs. 25% in 2001, according to a survey by benefits consultants Hewitt Associates Inc. Employers are also covering fewer Americans—60% last year, down from 64% in 2000. As a result, the ranks of the uninsured have jumped by 5 million since 2000, to 45 million. Loretta Marcin, a \$10.81-an-hour kindergarten aide in Carson City, Nev., says her medical premiums have jumped 50% since 2000, to \$200 a month, all but eclipsing the small pay hikes she has seen. "I'm making more than I was then, but I'm not taking any more home," says Marcin, 48, who says her husband, a self-employed construction worker, can't afford to be on her plan and thus has no health insurance.

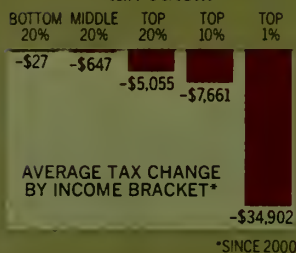
Average family net worth fell 5.5% since 2000

HOW FAMILIES ARE FARING: THE BUSH RECORD

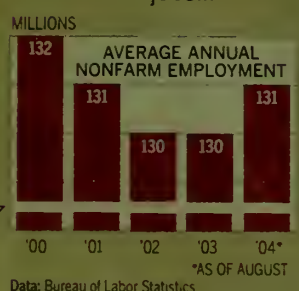
Americans have seen real wage gains...



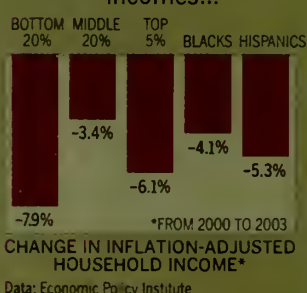
...and benefited from tax cuts...



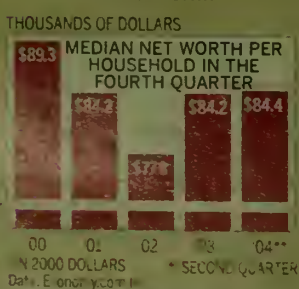
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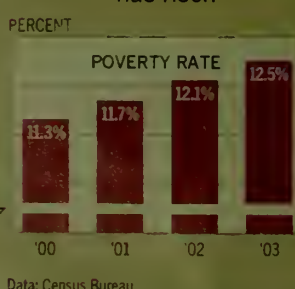
...has cut families' incomes...



...and their net worth has fallen...



...while poverty has risen



The Rich Get Poorer

AFFLUENT FAMILIES have been hit, too. Average family incomes of those in the top 5% have trailed inflation by 6% since 2000, sinking to \$253,000 last year—a \$16,000 drop. Meanwhile, the tax cuts gave them back an average of \$11,600, according to the Tax Policy Center. Economists think a lot of the lucrative stock options cashed in at the peak of the market boom dried up. In addition, many high-paid tech jobs got wiped out with the Internet bubble and haven't come back. Indeed, the jobless rate for computer scientists and electrical engineers hovered above 5% last year, a level neither had ever reached in more than two decades, according to an analysis of BLS data by Ron Hira, a public policy professor at Rochester Institute of Technology.

Bush advocates don't deny the negative numbers but argue that most families have been able to keep spending more nonetheless. The AEI's Hassett says that given how much people are buying, there's scant evidence of a middle-class squeeze. He points to a 2% rise in consumer spending from 2000 to 2002 among middle-income households. The numbers aren't available for later years, but Hassett predicts they will be better than during the recession. "The best measure of whether someone is better off is consumption, which has shown gains during the worst period," he says. In addition, Americans have continued to increase home ownership. Although the ownership rate bumped up and down in the recession, it started climbing again in 2003 and hit a record 69.2% in the second quarter this year.

Home equity loans and credit cards probably aren't the best ways to prop up your spending when your income stalls. Yet that's what many have done—lowering the median household's net worth from \$89,300 in 2000 to \$84,400 today, after inflation adjustments, according to Zandi's analysis of Federal Reserve Board data.

Of course, most families don't have an exact fix on how much they're worth at any given moment. This likely has muted the political impact of lower family incomes and higher debt. The overall reality is ambiguous and complicated—not the sort of stuff that is likely to move the political needle sharply. ■

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The Education of Peter Coors

Is a brand name and big money enough to make him the new senator from Colorado?

IT DIDN'T TAKE PETER H. COORS long to learn his first brass-knuckle political lesson. Scarcely six weeks after launching his bid for the U.S. Senate, the 58-year-old scion of the beermaking dynasty walked into a haymaker named Bob Schaffer. In debates leading up to the Republican primary, Coors stumbled badly as Schaffer, a Christian fundamentalist and former three-term representative, lambasted him about a 1997 interview in which he said he could support lowering the drinking age. Another time, Coors didn't recognize the name of Canada's Prime Minister, even though his company was negotiating a merger with Canadian brewer Molson Inc.

Yet Coors trounced Schaffer the old-fashioned way—with tons of cash. In the last two weeks of the primary race, he lent his campaign \$400,000, which helped pay for 400 red-white-and-blue billboards and a TV ad blitz that described

his humble beginnings—if sweeping floors at the family brewery qualifies as humble. Endorsements streamed in from GOP luminaries such as Jack Kemp and ex-Senator Alan K. Simpson (Wy.). Governor Bill Owens, who first backed Schaffer, climbed aboard the Coors train, too.

The outpouring of GOP support for a neophyte candidate with zero experience and a halting speaking style underscores how important Colorado has become to Republican chances of maintaining a slim 51-48 margin in the Senate (there is one independent). Polls show that Coors—on leave from his \$1 million-a-year job as chairman of Adolph Coors Co.—has closed the gap with popular state Attorney General Ken Salazar in the race to succeed retiring Republican Senator Ben Nighthorse Campbell.

But with the revival of John Kerry's Presidential campaign and no guarantee of a coattail ride from George W. Bush, the selling of Pete Coors is suddenly more

important than ever. "We're not going to let him lose," says Senator George F. Allen Jr. (R-Va.), chairman of the National Republican Senatorial Committee (NRSC). To help its candidate, the NRSC has promised Coors \$507,000, the maximum allowable under Federal Election Commission rules. And on Oct. 11, President Bush showed up to stump for Coors, even though on *Meet the Press* the day before Coors said Congress would not have authorized the invasion of Iraq if it had known "what we know now."

With the Coors name on everything from Denver's baseball stadium to music pavilions around the state—including the amphitheater where Salazar held a fund-raiser—the tax-averse Republican has recognition to burn. But the brand name can work against him, too: One in three Coloradans think brew when asked their opinion of Pete Coors, says pollster Lori Weigel of Public Opinion Strategies. "He's still the guy who does the [beer] commercials... to those folks."

"TOO MANY LAWYERS"

IN A RECENT DEBATE before a business group at a downtown Denver hotel, a more seasoned Coors looks every bit the candidate. Under the tutelage of NRSC staffers, his delivery is better—though he still stumbled on *Meet the Press*—and his grasp of numbers surer. "Litigation is a 3% hidden tax on business, and I'll work to get tort reform passed," he told the Colorado Association of Commerce & Industry. In a none-too-subtle reference to Salazar, a onetime private attorney, he added: "There are too many lawyers in the Senate as it is."

In Salazar, Coors faces his polar opposite, a populist who polishes his man o'

Rocky Mountain Face-Off

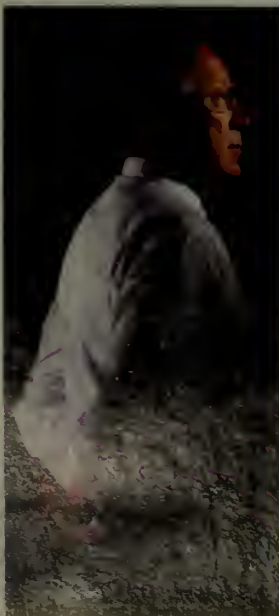
With control of the U.S. Senate at stake and no guarantee of Bush coattails, the Colorado race has turned into a toss-up

KEN SALAZAR, 49

- Born in rural Colorado, worked the family ranch before law school. Democratic Attorney general for the last five years.
- An avowed environmentalist, would raise taxes on the wealthiest 2%, wants tax credits for companies locating in rural areas.
- Devout Catholic. Pro-choice, supports death penalty, opposes constitutional amendment against same-sex marriage.
- Married, father of two. Favorite restaurant is the Dairy Queen owned by his wife, Hope.

PETE COORS, 58

- On leave from job as chairman of Adolph Coors. The Republican candidate is a familiar face from beer commercials.
- Favors hefty tax cuts, increased domestic oil production, reduced regulation on businesses.
- Devout Catholic. Opposes abortion, same-sex marriage, death penalty. Supports company benefits for gay partners.
- Married, father of six. Kicks back by fly fishing or gardening.



Data: BusinessWeek, candidate

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the people image by holding ice cream socials, touring the state in a dusty green pickup, and talking about growing up poor in a farmhouse with no electricity. With a résumé that includes securing water for rural communities, Salazar is strong in Colorado's usually reliable Republican countryside. His tough record on environmental crimes has won the approval of greenish independents, who make up nearly one-third of the state's some 3 million registered voters. And as a fourth-generation Hispanic, he appeals to the state's fastest-growing demographic group—an estimated 15% of the electorate. “He’s the Republicans’ biggest nightmare,” says Colorado State University political science professor John Straayer.

The candidates, both devout Catholics, pledged a clean race. But in recent weeks, the gloves have come off. On Sept. 30, Salazar accused Coors of “fronting for his drug-company backers” by opposing imports of lower-cost pharmaceuticals from Canada. The next day, a TV ad sponsored by the Democratic Senatorial Campaign Committee blasted Coors Brewing’s environmental record, calling it “one of Colorado’s biggest polluters” and claiming that it shed 900 jobs in the eight years that Pete Coors was CEO. (A company spokeswoman says that Coors has extensive environmental cleanup programs and that jobs were lost through mergers, not layoffs.) The DSCC also e-mailed articles to reporters about the beer company’s sponsorship of an annual gay festival in Montreal that features a male nude revue.

Unlike the early days of his campaign when he froze in the face of attack, Coors has hit back. He has aired ads questioning Salazar’s defense of polluters while a private attorney and charged that the Democrat would vote to slash the defense budget—a hot-button issue for the many military personnel in Colorado. And he shows no signs of letting up: With financial backers such as former football star John Elway and Denver billionaire Phil Anschutz, Coors will spend a record \$10 million—twice what it took to elect Senator Wayne Allard (R-Colo.) in 2002—says campaign manager Sean Tonner. Salazar expects to spend about \$8 million. If the race remains close, Coors says he won’t be afraid to pump in more of his own cash. Money talks is one of the lessons he has learned in the School of Political Brass Knuckles. ■

—By Ronald Grover in Denver

What Do Women Want? Des Moines

Progressive companies and easier lifestyles are luring working moms

EVERY DAY, ANNE GRIM commuted three hours round-trip from family-friendly Westport, Conn., to Lower Manhattan to put in a full day at American Express Co. There, as a general manager for customer-information management, she was responsible for a staff of 625 worldwide. After September 11, she quit to raise her second child and then have a third—but Grim, then 42, still longed for the intellectual challenge of the office. So last year, she put herself back in the job market, and soon a headhunter for Wells Fargo & Co. came calling. “San Francisco, right?” said Grim, intrigued. No, said the recruiter: Des Moines, Iowa. “That’s when I started laughing,” recalls Grim.

Meanwhile, in San Francisco, Kerty

Nilsson Levy—born in Japan, schooled in Sweden, and a former a quality-control supervisor for a caviar plant in Beijing—was also reassessing her life. She and her husband, two Harvard MBAs living on Nob Hill, had wanderlust for Turkey, Brazil, or Hungary. Or, suggested Levy’s husband, he could join his father’s real estate business in Des Moines, freeing up ample capital to comfortably start a family. “I agreed to go on a trial basis,” says Levy, 38.

Today, both Levy and Grim—along with more working mothers than in many other larger cities (table)—have made Des Moines their Shangri-la. Because of the town’s mix of attributes—big enough to be the No. 3 insurance hub but small enough to offer 10-minute, in-time-for-supper commutes—many women report that the work-family bal-

The Iowa Advantage

Des Moines’ quality of life beats the big cities*

	Des Moines	Los Angeles	New York	Chicago
PERCENT OF DUAL-CAREER FAMILIES WITH KIDS UNDER 6	70%	50%	52%	55%
WOMEN IN MANAGEMENT	70%	57%	49%	53%
AVG.. SINGLE FAMILY HOME	\$133,900	\$354,700	\$353,000	\$238,900
AUTO INSURANCE**	\$596	\$795	\$1,161	\$748
AVG.. HOSPITAL OUTPATIENT CHARGES PER VISIT	\$363	\$646	\$485	\$603
2004 SAT SCORES				
VERBAL	593	501	497	585
MATH	602	519	510	597

*Data is for greater Metro Areas. **Average annual combined premium including liability, collision, comprehensive. Shitewide figures † Avg. scores Data: U.S. Census, Greater Des Moines Partnership, National Association of Realtors, National Association of Insurance Commissioners, Iowa Hospital Assn., College Board, Morgan Quitno Press



RISHING
Grim and family after move to Des Moines

nce that was a mirage when they lived in bigger cities has now become a reality. says Grim, who took the Wells Fargo job after her husband, co-founder of an artificial-intelligence software company, said he was game: "I've got a great career with lots of opportunities—and I still have a life." Levy, the president of Des Moines' Downtown Community Alliance, is now the mother of two. "After six months here, we said: Forget it," Levy explains. "We're not moving back."

Des Moines bills itself as motherhood, apple pie—and a fast track to the top for working moms. Indeed, 70% of the managers in this city of 200,000 are women, the greatest percentage in America. That's nine percentage points more than Dallas and Indianapolis, for example, and 13 points more than Los Angeles, according to the Census Bureau. Professional women—including CEOs, legislators, and financial managers—outpace their male counterparts, according to the U.S. Equal Employment Opportunity Commission, 5,081 vs. 9,388.

Yet it's not as if moving there always amounts to paradise. "To me, it seemed like living there would be a slow death," said an East Coast publishing exec who turned down a high-ranking job at Meredith Corp., one of the town's biggest employers. The drawbacks: Downtown Des Moines is a warren of lookalike insurance company buildings. Most professionals live in the suburbs, a hive of subdivision

blandness. At Des Moines' innovative Downtown School, parents can drop off their kids and then walk to work through the toasty skywalk system. But the waiting list is long. The metro region's test scores are among the highest in the U.S., but overall the city school system is mixed, leaving many parents to put their kids in private school or leave town—the same dilemma faced by moms on the more expensive coasts. For the airlines, Des Moines is a spoke, making for longer trips. It still lacks a great regional theater—and until recently, it had only two Starbucks.

CRITICAL MASS

STILL, DESPITE ITS shortcomings, this midsize city in a state that is the No. 1 producer of corn and hogs is surprisingly appealing to manager moms. In the Des Moines metropolitan area, 70% of families with children under six have both parents in the workforce, beating the big cities (table). The working mom as the demographic norm offers a détente in the cultural war that often erupts elsewhere between stay-at-home moms and those who work. The critical mass also means companies have little choice but to cater to women. Ernst & Young and Bankers Trust allow women to design their own work schedules. Meredith offers the chance to buy more vacation with pretax dollars. At Principal Financial Group Inc., where two-thirds of its 14,000 employees are women, nursing

moms pump in deluxe lactation centers.

Some say the progressiveness goes all the way back to the co-CEO ethos between husband and wife on the family farm. Des Moines women were also the first to train with the U.S. Army when it opened its first auxiliary training centers there in 1942. Fostering women's corporate careers, however, became crucial in the 1980s, when the statewide farming crisis wiped out jobs. That left the male-dominated manufacturing jobs, but those, too, continue to dwindle. Des Moines worked hard to replace the lost farming and factory work by inviting employers in the service sector, which generally hires more women. Financial and insurance companies responded, drawn in part by the way even secretaries could afford nice homes. Today, Des Moines is third to Hartford and London as an insurance hub and has a thriving mortgage industry. As more women became employed, more moved up the ranks. "Once you get women at the top, they tend to bring other women with them," says Jann Freed, a business professor at Central College in Pella, Iowa.

Certainly, Des Moines isn't for everyone. But at a time when skyrocketing home prices, the threat of terrorist attacks, and a half-an-hour a day of face time with the kids are high on working moms' worry list, Des Moines offers a growing number of them some unexpected peace of mind. ■

—By Mara Der Hovanesian

The Man Who Could Have Been Bill Gates

A new book says Gates got the rewards due Gary Kildall. What's the real story?

THE SAGA OF THE COMPUTING industry is rich with outsize characters and surprising plot turns, but there's one story that has risen over time to mythic proportions. It's the tale of how software pioneer Gary Kildall missed out on the opportunity to supply IBM with the operating system for its first PC—essentially handing the chance of a lifetime, and control of tech's future, to rival Bill Gates and Microsoft Corp. In the process, he may have missed out on becoming the world's richest man.

The legend goes like this: One fateful day in the summer of 1980, three buttoned-down IBMers called on a band of hippie programmers at Digital Research Inc. located in Pacific Grove, Calif. They hoped to discuss licensing DRI's industry-leading operating system, CP/M. Instead, DRI founder Gary Kildall blew off IBM to gallivant around in his airplane, and the frustrated IBMers turned to Gates for their operating system. This anecdote has been told so often that techies need only be reminded of "the day Gary Kildall went flying" to recall the rest. While he's revered for his

technical innovations, many believe Kildall made one of the biggest mistakes in the history of commerce.

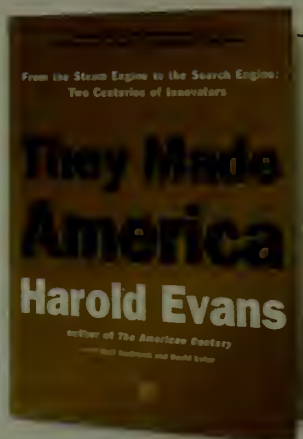
But what if that's not what happened? What if IBM and Microsoft deprived Kildall not only of untold riches but also of the credit for a seminal role in the PC revolution? That's the thesis of a chapter about Kildall in *They Made America*, a serious coffee table history book by renowned author and former newspaper editor Harold Evans. The book, published by Little Brown on Oct. 12, profiles 70 American innovators and is the inspira-

tion for an upcoming PBS series. And while other tech authors have debunked the gallivanting story before, Evans bases his Kildall chapter on a 226-page, never-published memoir written by Kildall just before his death in 1994. Early on, Kildall seemed to represent the best hopes of the nascent computer industry. But by the time he died at age 52, after falling in a tavern, he had become embittered

and struggled with alcohol.

They Made America is certain to elicit cries of protest. That's because it attacks the reputations of some of the key players of the early PC era—Gates, IBM, and Tim Paterson, the Seattle programmer

who wrote an operating system, QDOS, based partly on CP/M that became Microsoft's DOS. Evans asserts that Paterson copied parts of CP/M and that IBM tricked Kildall. Because Gates prevailed, according to the book, the world's PC users endured "more than a decade of crashes with incalculable economic cost in lost data and lost opportunities." David G. Lefer, one of Evans' two collaborators, says: "We're trying to set the record straight. Gates didn't invent the PC operating system, and any history that says he did is wrong."



How **Kildall** Lost Out

On a few fateful days in the early 1980s, PC software pioneer Gary Kildall missed the opportunity to supply the operating system for IBM's first PC—opening the door to rival Bill Gates of Microsoft. Here's how it happened.

AUG. 21, 1980 IBMers visit Bill Gates at Microsoft and lay out their plans for a PC. They discover that he can't supply an operating system. He refers them to Gary Kildall and Digital Research Inc., which has an

operating system called CP

AUG. 22, 1980 IBMers meet Digital Research in Pacific Grove, Calif., with Dorothy McEwen, Kildall's wife and DRI's business manager. IBMers say that they were

Computerworld 1982



There's no doubt that Kildall was one of the pioneers of the industry. He invented the first operating system for microcomputers in the early 1970s, making it possible for hobbyists and companies to build the first personal computers. Legacies aside, Microsoft's original DOS was based in part on Kildall's CP/M. His insight was that by creating an operating system separate from the hardware, applications could run on computers that were made by different manufacturers. "What really drove Gary was inventing things," says friend and former DRI executive Tom Rolander in an interview with *BusinessWeek*.

Still, Evans' book falls short of clarifying exactly how Kildall lost out to Gates.

He relies primarily on Kildall's memoir, his family, and his friends. Evans says he requested an interview with Gates, which he says Microsoft denied. He didn't make contact with IBM or Paterson, but tapped previously published accounts for that side of the story. IBM would not talk to *BusinessWeek* for this article, but former IBMers take issue with Kildall's version of events. Microsoft calls the book "one-

TWO VERSIONS

Kildall said he had a deal with IBM. But one IBMer says no

sided and inaccurate," and says the company is proud of the "foundational role" it played in the industry. Paterson denies he stole Kildall's intellectual property. He says he's stunned that the authors failed to get in touch with him. "You'd think they might have asked. I'm not hard to find," he says.

HAZY MEMORIES

WHAT'S HARD TO FIND is the truth. A dozen interviews by *BusinessWeek* with people on all sides paint a blurry picture of those crucial days in the summer of 1980. While Kildall claims in his memoir that he met with IBM that first day and reached a handshake agreement, DRI's own lawyer at the time, Gerry Davis, says there was no deal. One of the IBMers who visited DRI that day insists he didn't talk to Kildall, but another, Jack Sams, now retired, says it's possible he was introduced to Kildall, although he doesn't remember it. Sams says faulty memories and self-serving accounts make it nearly impossible to tell exactly what happened during those chaotic weeks. "Back in those days, there was a lot of misinformation that was deliberate," he says, pointing out that IBM originally claimed it had made the PC all by itself. "We spun it, Kildall spun it, and Microsoft spun it."

The story begins unambiguously. A group of IBMers, working on a secret project to build a personal computer, flew to Seattle in August, 1980, to see if Gates could supply them with an operating system. He couldn't—and referred them to Kildall. When they showed up at DRI's offices the next day, Kildall's then-wife, Dorothy McEwen, the company's business manager, refused to sign their nondisclosure agreement. She is now ill with brain cancer and can't remember the events, according to daughter Kristin Kildall. But Rolander, who flew with Kildall on a business trip that morning, tells *BusinessWeek* they returned in the afternoon and Kildall did meet with IBM.

If Kildall struck a handshake deal that day, it didn't stick. Sams says he did get together with Kildall in Pacific Grove a short time later, but they couldn't reach an agreement. At around the same time, he saw Gates again. He and Gates both

come to a nondisclosure agreement with McEwen, and didn't meet Kildall. But in his memoirs, says he with IBMers and reached an agreement to license to them.

AUG. 28, 1980 Gates signs a consulting contract with IBM, agreeing to develop software for the PC. Later he pays \$50,000 for an operating system, QDOS, that was similar to CP/M. Microsoft improves

QDOS, renames it DOS, and licenses it to IBM.

JULY 21, 1981 Kildall confronts IBMers with his claim that DOS infringes on his copyright for CP/M. He agrees not to sue in exchange for IBM's promise to

sell CP/M in addition to the PC.

AUG. 12, 1981 IBM announces its PC, offering CP/M for \$240 and DOS for just \$40. DOS far outsells CP/M and becomes the de facto standard operating software for the PC.

Data: *BusinessWeek* research, *They Made America* by Harold Evans, and *Gates* by Stephen Manes and Paul Andrews



knew of the operating system Paterson had built at Seattle Computer Co. As Sams recounts, "Gates said: 'Do you want to get [QDOS], or do you want me to?' I said: 'By all means, you get it.'" Gates bought Paterson's program, called QDOS, for \$50,000, renamed it DOS, improved it, and licensed it to IBM for a low per-copy royalty fee.

THE SHOUTING

IT WASN'T UNTIL nearly a year later that Kildall discovered that Gates, a longtime friend, had plucked the plum software deal out of his grasp. IBM sent test versions of its PC out shortly before it was announced in August, 1981, and a consultant working for DRI noticed the operating system was remarkably similar to CP/M. The consultant, Andy Johnson-Laird, remembers that Kildall looked at the screen and was stunned. "There were some shallow changes, but it was essentially the same program," says Johnson-Laird in an interview with *BusinessWeek*.

Kildall was furious. He and DRI's vice-president for marketing, John Katsaros, met with Gates in a Seattle restaurant to hash things out. "It was one of those meetings where everybody was nice to each other, then everyone shouted at each other, then everyone was nice to each other, then everyone shouted at each other," recalls Katsaros in a *BusinessWeek* inter-

view. Nothing was resolved. Kildall also confronted IBM. But his problem was that software copyright had just become law three years earlier, and it wasn't clear what constituted infringement. Davis, the DRI lawyer, believes that based on the number of similarities DRI's forensic consultants found between the original DOS and CP/M, "in today's world, you could take it to court and get an infringement." But not in 1981. So rather than sue, Kildall agreed to license CP/M to Big Blue. He was floored when the PC was released and IBM charged \$240 per copy for CP/M and just \$40 for DOS. Kildall's conclusion, according to his memoir: "I believe the entire scenario was contrived by IBM to garner the existing standard at almost no cost."

Within a couple of years, the IBM PC was the undisputed champ, and Microsoft was the leading operating system provider and on its way toward PC industry domination. CP/M gradually faded into irrelevance. Kildall ultimately sold his company to Novell Inc. in 1991 for \$120 million. He went on to create some pioneering multimedia technology, but never again was an industry player. Friends say that, for years, he cringed when people brought up the "flying when IBM visited" story.

The last straw was when

GATES IN 1985 His DOS was similar to Kildall's CP/M system

the University of Washington in 1992 invited Kildall to attend the 25th anniversary

of its computer science program. He was one of its earliest and most distinguished graduates, earning a PhD, yet they had picked as keynote speaker Gates, a Harvard dropout. Kildall says it was this dig that prompted him to write his memoir. "Well, it seems to me that he did have an education to get there. It happened to be mine, not his," Kildall wrote.

Kildall's resentment is understandable, but even his friends agree that he was partly to blame. For all his technical brilliance, he was a poor businessman. One big mistake was not moving ahead fast enough with a more advanced version of CP/M. He was slow to deliver a 16-bit operating system. It was that delay that created an opening for Paterson to design a 16-bit alternative, and because DRI didn't have its own version ready in the summer of 1980 IBM decided to deal with Gates, says Sams. Once IBM agreed to market his software, Kildall demanded a relatively high royalty—contributing to its being priced so high, say former DRI execs.

Would history have taken a different path if Kildall triumphed in those early days? "I'm convinced," says John Wharton, a tech consultant and Kildall pal. He believes the industry would have been more collegial and innovative if Kildall rather than Gates sat at the crossroads of computing. But others say Kildall didn't have what it took to lead an industry.

"Bill succeeded because he was a tenacious businessman," says lawyer Davis. "Gary was not tenacious."

As for Kildall's family, they're grateful his story is finally being told. "The truth is different for everybody," says daughter Kristin. "I think everybody believes they're presenting the truth. Obviously, they're different. I don't know why. I'm just glad my truth is out there." History may typically be written by the victors. But in this case, Gary Kildall has secured—and deserves—more than just a footnote. ■

—By Steve Hamm in New York and Jay Greene in Seattle



IBM and Microsoft came out on top, and Kildall's OS faded away

BusinessWeek online For a Q&A with author Harold Evans, go to www.businessweek.com/magazine/extra.htm

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BUSINESS TRAVEL

Lighten Up, Road Warriors

How to keep all your electronic gizmos to under 10 pounds. **BY CLIFF EDWARDS**

THE OLDER I GET, the more every business trip seems to tax my shoulders and back. Looking at my typical travel gear, it's no wonder. My Dell D600 laptop, extra battery, and adapter plug alone weigh about 10 pounds. Add in a book, papers, movie DVDs, my Samsung cellular phone, iPod music player, Canon EOS Digital Rebel camera, Bose headphones, and more cords, adapters, and chargers needed to make the trip enjoyable, and you can see why a lot of people hate to travel. ♪ That's why in

planning a trip to Europe earlier this year, I decided to see if I could slash the weight of my gear from 25 pounds to 10. I hunted, online and in stores, for light, easy-to-use stuff that didn't trade weight for costs higher than my original gear. Altogether, I got good results—and would recommend the equipment.

I decided to ditch my 10-pound, \$2,200 Dell laptop, which I used mainly to get to e-mail behind the corporate firewall. I first opted for palmOne's 6-oz. Treo 600 handheld phone—organizer that could do double duty: I could get rid of my phone and easily send and receive e-mail, since McGraw-Hill, *BusinessWeek's* parent, offers Good Technology's wireless e-mail service. All I

had to do was make sure my carrier, AT&T Wireless, supported data roaming overseas—and it did.

Then I began to worry. Could I go on the road for 18 days with just the Treo's tiny keyboard? Back on the hunt, I found Sharp's Actius MM20P. Weighing an amazing 2.6 pounds, with a 10-inch screen, the \$1,600 machine could serve as a good travel PC. I could work in Word or Excel and, because the Actius had built-in Wi-Fi, I could access my Yahoo! e-mail account to forward information to colleagues or my own work e-mail account, while using the Treo to send shorter messages directly. (I also carried Apple AirPort Express with AirTunes, which al-

lowed me to set up a Wi-Fi hot spot anywhere.) Better yet, the Actius came with a dock I could leave at the office. Connect the dock by USB to your primary computer, and the Actius' 20-gigabyte hard drive can serve as an external storage device. The downside? There's no internal DVD-ROM drive.

GOOD-BYE IPOD

THAT LED ME TO MY second big decision—going without my iPod. I decided to address my entertainment needs by using Archos' AV400 pocket video recorder. With the hard-drive player, I recorded *MADtv* and *Nip/Tuck* episodes off my TiVo for long plane and train rides. My stress levels kicked up a notch, however, when I discovered I couldn't transfer my music library to the device. I had been saving much of my catalog in the Apple iTunes' proprietary AAC format, which wasn't supported by Archos. So I had to rerecord a few CDs in the MP3 format.

My biggest headaches came with the decision to use Sony's ultracool Cyber-shot DSC-T1 5 megapixel digital camera. As thin as a few credit cards stacked together and weighing just 6.3 ounces, it seemed a good replacement for the bulkier, 2.5-pound Canon. But I was put off by the Cybershot's lack of a regular viewfinder. Worse, I discovered after getting home that quite a few pictures were blurry despite the relatively fast shutter speed. Perhaps the camera was so small that tiny shakes of my hand led to fuzzy photos.

A good option for those who need a travel printer: the HP Deskjet 450. Equipped with Bluetooth wireless communications and weighing just 4.6 pounds, it was compact enough to carry and could easily pair with the Sharp Actius using a Bluetooth adapter.

I turned to Targus for my final weight-savers. The Targus World Pack Travel Connection kit comes with every power and landline phone adapter. I added the company's 11-oz. Universal Auto/Air Notebook Power Adapter kit and got rid of all my other cords except those for the Treo 600. Then I loaded all the gear in a lightweight notebook case.

So how did I do? Total weight: 10.2 pounds, and just 5.63 pounds if I left the printer home. Total cost: \$3,357, or \$3,107 without the printer. While not cheap, it still cost less than my regular gear. I'll trade a thinner wallet for a lighter load any day. ■

2 What our readers think about airlines

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122 Barker: No. 2 in office stores



Treo 600
Weighing 6 oz., palmOne's one-organizer can be used online for as little as \$199

Archos AV400
The \$499 Pocket Video recorder, just 9.88 oz., records movies, TV shows, and music

Sharp Actius IM20P
Only 2.6 lb., this \$1,600 portable laptop gets just middling battery life but has built-in Wi-Fi capability

4 Logitech V500 Mouse
Form meets function with this sleek \$60 wireless travel mouse

5 Targus Travel Connection Kit-World Pack
The \$99 kit for different power standards has 23 adapters to choose from. Add the 11-oz., \$129 Targus 120 watt AC/DC adapter, and you'll stay in business

6 Airport Express with AirTunes
Weighing 6.7 oz. and costing \$129, it makes setting up a wireless network easy

7 Plantronics M3500 Bluetooth Adapter
Use this 9-oz., \$150 headset with Bluetooth-enabled cellphone

8 HP Deskjet 450
Need documents on the go? The 4.6-lb., \$350 printer offers 8.5 x 11" copies and prints photos. The unit can be battery-powered, and also has Bluetooth

9 Palm Tungsten T5
At 5.1 oz., this \$399 PDA can double as a USB hard drive. Add a wireless keyboard and leave your PC at home

10 Sony Cybershot DSC-T1
Just 6.3 oz., the \$550 T1 offers 5.1 megapixel shots. It sports a 2.5" LCD screen, but no view finder



STILL NO. 1 Carriers such as United have the advantage of broader networks

Mutual Group based in Dallas. Richard Woodard is familiar with both American

and Southwest, which are also based in that city. His preference: American hands down. Recently, to save \$100, he took a Southwest flight. The "cattle call" at the departure gate to claim a seat drove him nuts. On American, he often gets bumped up to first class and can board ahead of the pack thanks to his status as 100,000-mile-a-year flier. "They make every effort to take care of the business traveler," he says.

Not everyone, of course, is smitten with the traditional airlines. Southwest came in third as most-liked carrier. "The majors have definitely declined in every aspect," says Lyle Kenaga, a national sales manager in Nashville for cleaning-supply manufacturer Spontex, who flies on Southwest whenever he can. Even most-liked United was named least favorite by 14.7% of the survey respondents.

SINGLED OUT

ONE REASON THE traditional airlines dominate the best and worst lists might be that they also dominate the industry. The network airlines and their regional affiliates still carry 7 of every 10 passengers in the U.S. The more familiar people are with a subject of a survey, whether it's a political candidate or a carrier, the more likely they are to single them out, whether for bouquets or brickbats. Also, business travelers tend to expect more from the majors, so it's easier for them to trip up.

The survey responses also show that business travelers are swayed by more than cheap seats. You want the airline with the best schedule and fewest stops. You want an assigned seat. You want a frequent-flier program that gives you free upgrades and overseas tickets. And you cherish the little things, whether it's automatic rebooking or, like Danny Rocks, vice-president at music publisher Alfred Publishing in Los Angeles, a flight attendant wishing you a happy birthday.

Most times, there's ample reason to fly on the major airlines. For one, they typically match discount-carrier fares. In addition, most of you now make your own

BUSINESS TRAVEL

The Big Airlines' Loyal Fans

A survey shows old-line carriers have hung on to some devotees: Business travelers. **BY MICHAEL ARNDT**

MARK KRISTENSSON, a software designer with Onyx Software, jets off from Salt Lake City three times a month to see clients. When he books a flight, he usually has plenty of options, from discount carriers such as Southwest Airlines and JetBlue Airways to Delta Air Lines. Mostly, though, he sticks with United Airlines. He loves the extra legroom in its Economy Plus seats and the frequent-flier perks. But what keeps United his top choice, Kristensson says, is its route network; he can get

almost anywhere anytime on United.

These days, most everyone wants to bash the old-line carriers. But they're still No. 1 with an important group: business travelers. We know because you told us. In *BusinessWeek's* first online survey on air travel, we asked subscribers and Web site visitors about their preferences, including their favorite and least-favorite carriers. Some 1,250 of you logged on to businessweek.com over the past six weeks to vote. Your faves? United, the top pick of nearly 1 in 5, with American Airlines, its bigger rival, in second. The worst? Their nemesis, the no-frills giant, Southwest.

As sales-development rep for CUNA

Frequent-Flier Portrait

What road warriors say about their trips

12.5

Average business trips in a year

54%

Book their business flights online

36%

Choose cheaper flights when on business

63%

Choose cheaper flights when they pay



WHO'S DRIVING THE HYDROGEN ECONOMY?

A BRIEF INTRODUCTION TO THE NEXT GENERATION OF GM.

The hydrogen economy isn't a pipe dream. And it isn't the buzz du jour on the front page of the business section. The hydrogen economy is the endgame of a multi-faceted strategy GM set in motion years ago, with steps that are real, progressive, and well-underway.

Internal combustion engine. GM has always been, and will continue to be, one of the leaders in fuel economy and emissions technology. Five cylinders delivering the power of six. Six delivering the power of eight. Smarter systems available in millions of GM vehicles right now. In fact, GM has more car and truck segment fuel economy leaders than any other manufacturer.*

Hybrids. Powered partly by engines, partly by batteries, hybrids deliver improved fuel economy with uncompromising performance. Last year we announced an aggressive plan to take some of our most popular models and offer hybrid versions of them. Cars, trucks, SUVs and buses you already know and trust, with an extra boost at the fuel pump.

Hydrogen. The destination is the hydrogen economy. A generation of cars and trucks powered by hydrogen, where the only emission is water vapor. GM introduced the first fuel cell-powered concept vehicle nearly forty years ago. And we've continued to push fuel cells forward ever since. Right now, a test fleet of GM fuel cell vehicles is negotiating traffic in downtown Tokyo and Washington, D.C. Right now, GM has over five hundred engineers on three different continents working on hydrogen solutions.

We're making sure children today are in cleaner cars tomorrow. And in the driver's seat of the hydrogen economy.



gm.com

CHEVROLET PONTIAC BUICK CADILLAC GMC OLDSMOBILE SATURN HUMMER SAAB

*Based on Ward's segmentation and 2004 model year EPA estimated mpg city and highway leaders

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arrangements on Internet airline and travel sites, so it's your call. Besides, you're busy people, and your time is worth some premium.

Kristen Howe is another *BusinessWeek* subscriber who helped make United No. 1. An account manager with Corporate Executive Board, a Washington consultancy to upper managers, Howe flies about once a week somewhere in the eastern third of the U.S. and always chooses United if she can. Why? "Their customer service is great," she says. Gate agents make it easy to get on earlier flights, for instance, if she arrives at an airport sooner than planned. They also help if she's running late. Just the other day, Howe got to the departure gate at Chicago's O'Hare International Airport to find the jetway door already closed. An agent reopened it so she could make the flight.

Granted, Howe's business won't hasten United's emergence from Chapter 11. But such loyalty can't hurt. And after reading their companies' obituaries day after day, it must be gratifying for workers at the old airlines to hear that at least one group still favors them. ■

What You Told Us About Air Travel

We asked you, *BusinessWeek* readers and visitors to businessweek.com, to tell us about your air travel habits. Some 1,250 of you responded. Here are some highlights.

WHAT IS YOUR FAVORITE AIRLINE?

United	19.2%
American	18.9
Southwest	12.6
Continental	12.4
Delta	11.2

YOUR LEAST FAVORITE AIRLINE?

Southwest	15.9%
United	14.7
US Airways	13.5
Northwest	12.7
Delta	11.2

BusinessWeek online For the complete survey results, go to businessweek.com/magazine/extra.htm

Power Eateries

When you don't know the lay of the land, picking a place for a business meal can be tricky. You want to be where the power brokers are, but you don't want to be treated like a second-class citizen.

BusinessWeek bureaus suggested spots where the corridors of power intersect with great cuisine and service. Find more at www.businessweek.com/magazine/extra.htm

—Suzanne Woolley

ATLANTA

LUNCH Bone's Restaurant
3130 Piedmont Road;
404 237-2663;
bonesrestaurant.com

PRICES: Entrées from \$9.95 (Bone's burger) to \$38.95 (New York Strip, 20 oz.). A place to enjoy big steaks and seafood in a clubby atmosphere; more delicate eaters can order the chunky lobster bisque and plenty of veggies à la carte.

BOSTON

DINNER Mamma Maria
3 North Square; 617 523-0077; mammamaria.com

PRICES Entrées from \$23 for mushroom ravioli to \$35 for osso buco. Housed in a 19th century townhouse in Boston's historic North End, this Northern Italian restaurant has five dining rooms that create an intimate atmosphere.

CHICAGO

LUNCH Nine
440 W. Randolph St.,
312 575-9900; n9ne.com

PRICES Entrées from \$13 for "fire chicken" to \$21 for an 8-oz. filet mignon. This steak and seafood spot is trendy but quiet enough at lunchtime to talk business, with roomy booths and plush seats.

DINNER TRU
676 N. St. Clair St.;
312 202-0001;
trurestaurant.com

PRICES Three-course prix fixe is \$80; a 10-course meal is \$135. This elegant French spot is a hot place for Chicago's

power diners. Ever try "deconstructed beef tartare"?

HOUSTON

BREAKFAST/DINNER The Remington Restaurant
St. Regis Hotel, 1919 Briar Oaks Lane; 713 840-7600; theremingtonrestaurant.com

PRICES The American breakfast (juice, eggs, ham, sausage, coffee) is \$19; a lavender-scented lamb loin dinner is \$30. The Remington offers an elegant main dining area as well as seating in a palm-filled atrium.

LOS ANGELES

BREAKFAST Four Seasons
300 South Doheny Drive,
310 273-2222; fourseasons.com/losangeles/

PRICES \$12 for two eggs; \$21.75 for Petit Filet Mignon with eggs. The Polo Lounge of our generation, this classic power spot is six blocks from Beverly Hills.

NEW YORK

BREAKFAST 540 Park (at the Regency Hotel)
540 Park Ave.; 212 339-4050; loewshotels.com

PRICES From \$10 for Irish oatmeal to \$25 for a full American breakfast. Power brokers of all stripes gather at this breakfast hot spot, with the real scene unfolding in the main dining room before 9 a.m.

DINNER Pastis
9 Ninth Ave.; 212 929-4844; pastisny.com

PRICES \$17 for moules frites au Pernod to \$26 for

HOUSTON
Remington Chef
Toby Joseph



steak frites with sauce béarnaise.

A super-trendy bistro in the red-hot downtown meatpacking district.

PHILADELPHIA

DINNER Striped Bass
1500 Walnut St.,
215 732-4444;
stripedbassrestaurant.com

PRICES From \$32 for organic Scottish salmon to \$44 for roasted Canadian lobster. Housed in a converted brokerage house building, this seafood restaurant is grand yet perfectly comfortable.

SAN FRANCISCO

BREAKFAST Bob's Steak & Chop House
Omni Hotel, 500 California St.; 415 273-3085;
bobs-steakandchop.com

PRICES Brioche french toast is \$10.95; steak and eggs is \$19.95. Located between the financial district and North Beach, this favorite spot of bankers and financiers is classic Corporate America in style and menu.

WASHINGTON

LUNCH The Oceanaire Seafood Room
1201 F St., NW; 202 347-2277; theoceanaire.com

PRICES From \$15.95 for Dungeness Crab Louis to \$27.95 for grilled Columbia River king salmon. The retro atmosphere in this lobbyist hangout is cool New York; Big Band music plays in the background.

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Shared at 2:15



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BUSINESS TRAVEL

Rating Frequent-Sleeper Plans

Hotel programs are getting generous, but they're trickier than airlines'. **BY CHRISTOPHER PALMERI**

JUST LIKE THE AIRLINES, NEARLY every major hotel chain now boasts a customer-loyalty program to lure repeat guests. Unlike frequent-flier plans, which typically grant points for miles flown, hotel programs are usually based on dollars spent, including the cost of the rooms, food, and other services but not taxes. Charge \$100 to your room, and you get some multiple of that in points. Accumulate enough points, and you get a free room.

Beyond that, hotel plans are far more complex. With frequent-flier programs, 25,000 points gets you anywhere in the lower 48 states, assuming you book far enough in advance and don't travel on a blackout day. Hotel plans require different amounts of points for different properties. Hilton Hotels, for example, has six categories that cost from 7,500 points for a night at a Hampton Inn to 40,000 points at the Waldorf-Astoria. At Hilton, every dollar yields 10 points, so to get that Hampton Inn room costs \$750 in spending at any Hilton property.

FINDING FAVOR

COMPARING THE PROGRAMS gets even trickier, because after a certain number of stays, your ability to earn points increases. Marriott's Rewards program has three "Elite" levels of membership. Regular members earn 10 points for every dollar spent at a Marriott property. But if you stay 10 nights per calendar year, you earn 20% more in bonus points. Stay 75 nights, and you get a 30% bonus.

There are some important differences between plans—enough to make you favor one over another. Hilton lets you earn both points in its HHonors program and frequent-flier miles on an airline of your choice based on the same hotel stay. Other companies, such as Starwood Hotels &

Resorts Worldwide (Westin, W, and Sheraton) have no blackout days, so if a room is available it's yours for points.

While airlines have made it a little harder and costlier to use frequent-flier miles since September 11, hotels have gotten more promotional. Many now have tie-ins with credit cards. Use any MasterCard for two stays at a Hyatt Hotels property between now and Feb. 28, 2005, and you get a night free. Many chains are also allowing guests to earn points through spending at certain restaurants and car-

rental chains and to exchange points for everything from Tumi luggage to gift certificates at Best Buy.

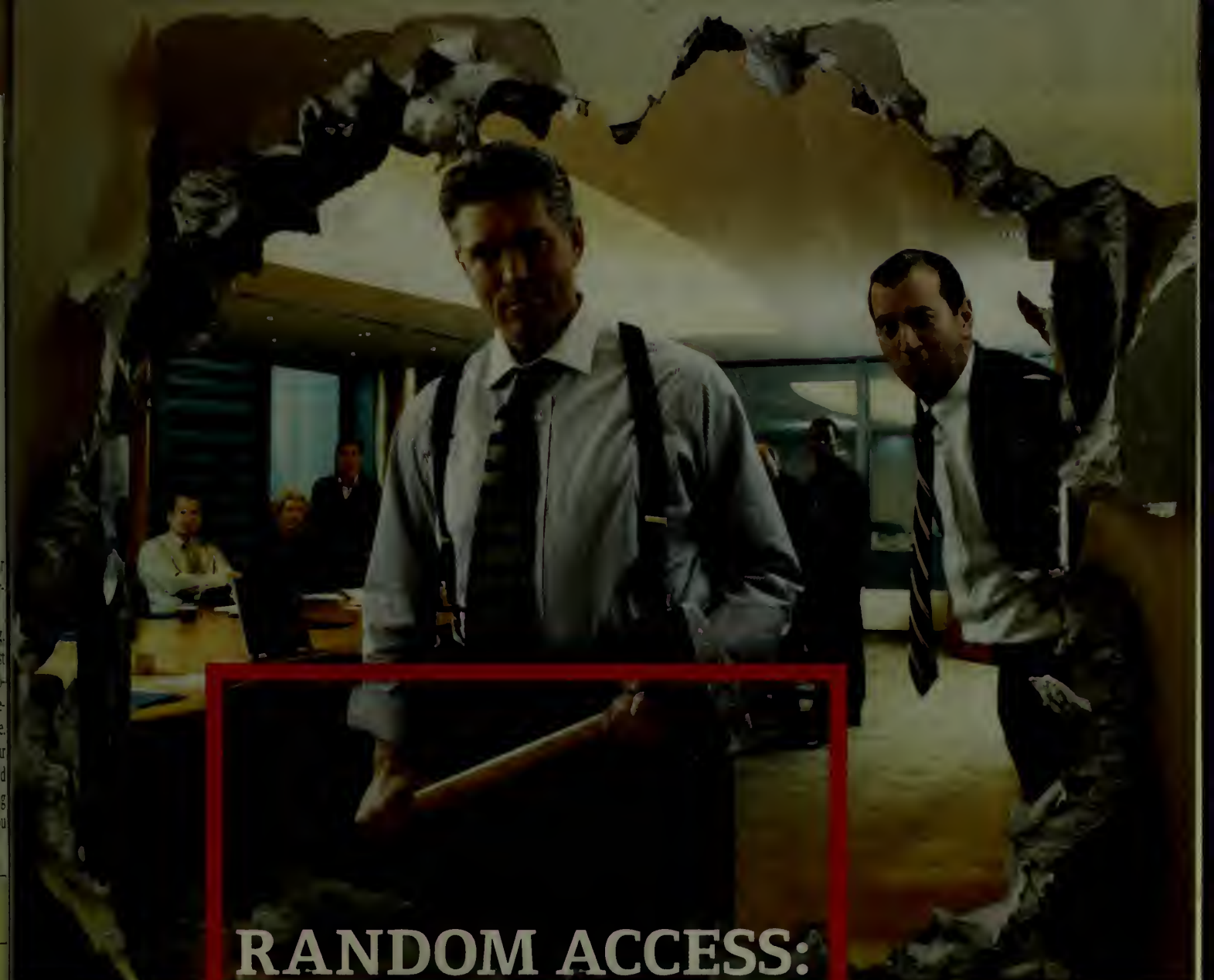
While special offers may be enticing, you should find the hotel chain that best fits your travel habits and focus on its program, says Tim Winship, publisher of frequentflier.com, a travel information site. That may mean staying in a hotel in your plan that's less convenient than you'd like. Walking a few more blocks or driving a few extra miles, though, will get you those free rooms faster. ■

Perks for Points

PROGRAM	AVAILABLE AT	YOU EARN	FREE NIGHT*
HILTON HHONORS 800 HHONORS, www.hiltonhonors.com	Hilton, Doubletree, Embassy Suites, Hampton Inn	10 points for every dollar spent on rooms, food, spas	\$750, Hampton Inn
HYATT GOLD PASSPORT 800 228-3360, goldpassport.com	Hyatt, Hawthorn Suites	Five points for every dollar spent at Hyatt; three at Hawthorn	\$1,000, Hyatt
INTERCONTINENTAL PRIORITY CLUB REWARDS 800 272-9273, priorityclub.com	InterContinental, Crowne Plaza, Holiday Inn, Staybridge Suites, Candlewood Suites	10 points per dollar spent, except Intercontinental. 2000 points per stay	\$1,000, Holiday Inn Express; 15 stays, Intercontinental
MARRIOTT REWARDS 800 228-9290, marriottrewards.com	Marriott, Renaissance, Courtyard, Residence Inn, Fairfield Inn**	10 points per dollar spent	\$750, for a Fairfield Inn
RADISSON GOLD POINTS 800 508-9000, goldpoints.com	Radisson, Country Inns, Park Inn, Park Plaza Hotels	1,000 points per night at Radisson; others 10 points per dollar	20 nights at Radisson; \$1,500 at others
STARWOOD PREFERRED GUEST 888 625-4988, spg.com	Sheraton, St. Regis, Westin, W Hotels	Two points for every dollar spent	\$1,000, at a Four Points by Sheraton

*Minimum outlay to get enough points for one full room

** Also TownePlace Suites, SpringHill Suites. Data: InsideFlyer.com, BW



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Yellow Light on the Street?

This long-watched volatility index is looking bearish. **BY TODDI GUTNER**

GIVEN RECORD HIGH oil prices, turmoil in Iraq, rising interest rates, and a closely fought U.S. Presidential election, you'd expect the stock market to be volatile—subject to big, sudden movements. Yet the market is registering some of the lowest volatility readings in nearly 10 years, as measured by the Chicago Board Options Exchange (CBOE) Volatility Index, better known as the VIX.

The VIX, a long-watched sentiment indicator, is grounded not in the stock market but in the options market—specifically, the options on the Standard & Poor's 500-stock index. Options traders bid up prices when they expect volatility to pick

up, and pay less when they don't. The VIX is calculated using current options prices, and since options are short-lived instruments, the prices incorporate some expectation of market volatility. The current level is 15. (Go to cboe.com/micro/vix/historical.aspx for current and historical VIX data.)

The VIX tends to have an inverse correlation with the stock market: As stock prices rise and investor fear subsides, option prices, and the VIX, fall. At some point, complacency takes hold, making the stock market vulnerable to a sell-



off. During market declines, the VIX usually rises. A rally can start when pessimism is rampant and no one feels good about stocks.

Now, the VIX may be signaling that the market is ripe for a fall. Since options prices are low, it's a good time to buy put options, or puts for portfolio protection.

(Puts rise in value when the underlying security falls; calls go up in value when the underlying security rises.)

Just look at VIX behavior over the last 6 to 12 months. The VIX has a tendency to hit a new low before the market falls and

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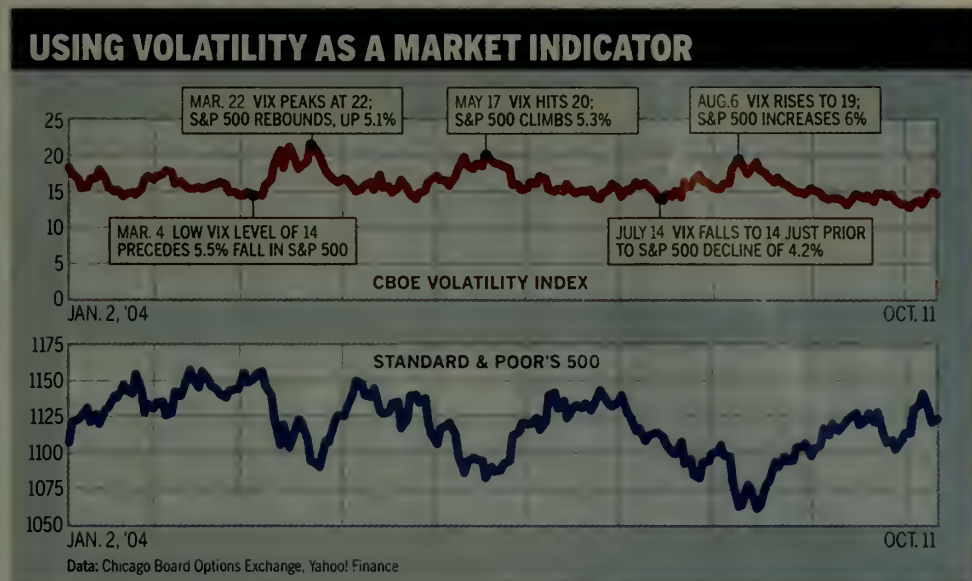
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new high ahead of a rally (chart). For example, in March, May, and August of this year, low VIX levels preceded a fall in the S&P 500 of 5.5%, 3.3%, and 4.2%, respectively. Also in March, May, and August of this year, the VIX hit new highs, and there were rebounds in the S&P of 1%, 5.3%, and 6%.

ARROW RANGE

Some pros are wondering if the historic interpretation of the VIX is still valid. As the market becomes less volatile, or as investors brushing off the economic and political risks? "There is a lot of unreasonable optimism in the market with the VIX as low as it is," says Chris Johnson, director of quantitative analysis at Chaeffer's Investment Research in Cincinnati.

Another way to put it is that investors are thinking that the market behavior in the future will be like the recent past. After all, even though there have been some sharp moves this year, the Dow Jones industrial average and the S&P 500 have been stuck in a narrow trading range. There's another dynamic at work. With a go-nowhere market, many managers are selling call options to create extra in-



come. That depresses the VIX as well.

As a result, some strategists think investors could be missing the S&P's warning light. "We could be in the first stage of a bear market, but no one believes it, so no one buys protection and the VIX remains low," says James Bittman, senior instructor at the CBOE Options Institute.

While it's too early to tell if a bear market is in the offing, Price Headley, chief

analyst at BigTrends.com, an options site, sells stocks and buys puts when the VIX gets below 14, and buys stocks when it rises to 20. "It has been a great strategy for this year," he says.

Maybe the VIX will remain low, and nothing bad will happen. But a bit of portfolio protection at this point won't cost a lot, and it can ease your anxiety in these risky times. ■

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EDITED BY TODDI GUTNER



TIME OFF

Modernist Marvels

REPRODUCTIONS OF THESE 19th and 20th century modern masterworks adorn countless family rooms and college dorms. Now, here are a couple of chances to see the originals.

In Los Angeles, *Renoir to Matisse: The Life of Duncan Phillips* runs through Jan. at the **Los Angeles County Museum of Art** (lacma.org). The exhibit showcases more than 50 European masterpieces from the **Phillips Collection** in Washington, in a setting designed to evoke the intimacy of the legendary collector's home when he opened it to the public in 1921. It features the collection's cornerstone, Renoir's large-scale *Luncheon of the Boating Party*, and such other memorable works as Picasso's *Bullfight*.

At the **High Museum of Art** in Atlanta (high.org), *Van Gogh to Mondrian: Modern Art from the Kröller-Müller Museum* includes 20 Van Goghs, including his *Café Terrace at Night* (*Place du Forum*), shown above. The exhibit opens this month in its final appearance before heading back to the Netherlands in January. Many of the works had not been seen in the U.S. in more than 50 years.

—Larry Armstrong, Carol Marie Cropper

HALLOWEEN

BUT I WANT TO BE LASSIE!

THE TRICK MIGHT be on Rover this Howl-o-Ween. A recent survey by mall operator **Macerich Co.** found that one-fifth of pet owners plan to dress their furry friends in costume this year. At **PetsMart** stores (or petsmart.com), most costumes cost less than \$15, and one-piece devil and witch outfits are among the most popular choices for dogs. Cats—especially black ones—already have the right attire, but they can still bat around PetSmart's \$2.99 felt toy pumpkin. —Lauren Young



RETIREMENT PLANS

Are you paying a reasonable amount in expenses for your 401(k)? You can check by asking your benefits department to tell you the **expense ratio** and any **other fees** for your plan, as required by law, and then compare the total to the average cost of a similar-size plan listed below. The figures were compiled by HR Investment Consultants of Baltimore in the *401k Averages Book*. —Anne Tergesen

PLAN SIZE	AVERAGE COST*
50 participants	1.40%
100 participants	1.31
200 participants	1.26
500 participants	1.20
1,000 participants	1.17
5,000 participants	1.12

* These costs assume an average per participant balance of \$40,000
Data: 401k Averages Book

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of Employees
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BY ROBERT BARKER

A Surprise in Office Depot's In-Box?

Just past 5 p.m. the other day, I waited in line at the local Office Depot to pay some princely sum for computer printer ink. Then, zap, the lights went out. A little sunlight filtered through the front door, but no money would change hands now. Or would it? Seven minutes later, a backup power system restored the lights. Cash registers began beeping again as if nothing were amiss.

An odd occurrence, but it transmits the vibe around Office Depot. Things suddenly go wrong, then the company muddles through and makes money. The latest outage, if you will, struck on Oct. 4 with the exit of CEO Bruce Nelson. Until they hire a permanent successor, company directors installed one of their own, Neil Austrian, a former Wall Streeter and once president of the National Football League. He told investors the board acted to ensure faster execution of plans to boost sales at its North American stores. Might Office Depot at last gain on archrival Staples, which leads it by many measures?

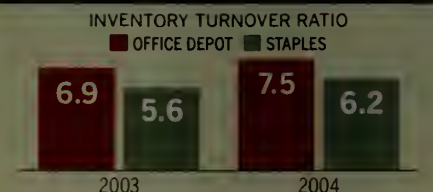
AT LESS THAN \$15, OFFICE DEPOT shares

have gone nowhere since 1997, when Uncle Sam blocked a merger with Staples. Meantime, shares of Staples have risen to \$30 from \$12. Investors like its profitability (a first-half pretax margin of 6%, vs. 4% at Office Depot), and growth (2004 same-store sales up 4%, vs. 3%). In 2003, Staples for the first time generated over \$1 billion in cash flow from operations, way beyond Office Depot's \$652 million.

So the market has had plenty of reason to mark down Office Depot. Investors, however, don't yet seem to be paying full attention to the company's growing skill at managing inventories, a vital sign of retailing health. One way this is monitored is by what's called the inventory turnover ratio, or a retailer's cost of goods sold divided by the average value of



GETTING SHARPER



its inventories. This measures how hard an investment in inventory is working; the higher the ratio the better. Office Depot, with a set of "crossdocks," or flow-through distribution centers where goods barely touch down before heading to stores, plus big, recent investments in information technology, is picking up its pace. Not only does quicker turnover tie up less cash in inventories but it also cuts the risk that goods will grow obsolete before they're sold—not so crucial in paper clips but particularly so in computers and other technology items. Although Staples also is turning inventories faster (and suffers a bit in the comparison as its total sales include a smaller proportion from nonretail, direct-to-business accounts), Office Depot enjoys the edge here (chart).

However critical, inventory management alone won't speed Office Depot's growth in profits. As is, Wall Street sees this year's earnings reaching perhaps \$1.10 a share, up nearly 15%, from 96¢ in 2003. Office Depot expects to have opened 80 new stores by the end of the year but is picking up the pace with an additional 100 in 2005. If the new stores help the company drive more sales through its increasingly efficient distribution system, the effect on profits could be surprisingly robust.

Shareholders, in any case, already are set to be nicely surprised, as Office Depot has set aside \$515 million in cash to repurchase stock over the next 12 to 24 months. At the stock's current level, the full buyback would cut total shares by nearly 11%. This could be a powerful propellant to earnings per share. Suppose net income grows next year by about 15%, to \$400 million or so. Without a buyback, that implies earnings per diluted share of \$1.26 in 2005. If by the end of next year, Office Depot were to use half of its budget for repurchases at an average of \$15 a share, net income of \$400 million would work out to \$1.33 in earnings per share—a 20% jump. No question, without a permanent CEO, Office Depot's future is hard to see. My bet is that the lights will be coming back on soon. ■

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DODGE

BY GENE G. MARCIAL

A 2005 REBOUND MAY BE IN STORE FOR **PAR PHARMACEUTICAL**.

OMNIVISION: IN THE VIEWFINDER OF MORE CELL-PHONE CAMERAS.

AN INTERNET ENGAGEMENT RING PROBABLY MEANS **BLUE NILE**.

Par: Out of the Rough?

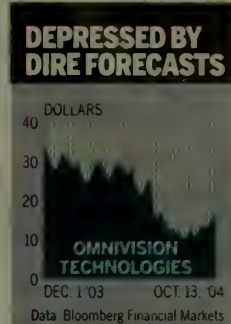
SINCE POSTING disappointing earnings in April, Par Pharmaceutical (PRX), No. 6 in U.S. generic drugs, has seen its shares plummet—from 61 to 34. Delayed earnings of three drugs and a few price drops have crimped earnings. But some pros see an upturn. Significant earnings drivers are on the way, says David Buck of Buckingham Research Group, who pegs Par a strong buy, with a 12-month target of \$40. He expects Par to get approval in early 2005 of its generic version of Ultracet, an acute-pain treatment with U.S. sales of \$300 million, now marketed by Johnson & Johnson). Par is being sued by Ultracet's maker, Endo-McNeil, claiming it infringed on a patent, which Par denies. A decision is expected in mid-2005. Adam Greene of First Albany Capital is an Ultracet generic would add 70¢ a share to earnings—even without it, he calls Par "attractive." It has an impressive pipeline" with 40 generic drugs awaiting Food & Drug Administration O.K. Par now makes 80 prescription generic drugs. Greene, who tags the stock a strong buy, says Par has signed pacts with biggies to produce generics of their drugs—with sales of more than \$1 billion. The generic versions, he figures, could get approval in 2005. Greene estimates 2004 earnings of \$2.51 a share, and \$3.04 in 2005—still below 2003's \$3.60.



Brighter Cell-Phone Picture for OmniVision

OMNIVISION TECHNOLOGIES (OVTI) had been riding the wave in digital cameras and cell phones that take pictures. OmniVision makes single-chip sensors for capturing images in such devices, which account for 83% of revenues. In early 2003, its stock was at 8; by Dec. 1 it hit 29, and, despite profit-taking, traded at 29 in early April. But skeptics began to argue that sales growth would slow. On June 9, OmniVision delayed reporting earnings for fiscal 2004 ended Apr. 30—it had to restate financial results for the first three quarters of that year. By August, the stock had fallen to 9 and it has since trudged up to 14. The restatement, caused in part by delayed bookings of revenues, actually resulted in higher earnings, says Chris Hackett, who heads

Greenwich Investments and calls the skeptics wrong. He predicts that OmniVision's customers, who account for half the cell-phone camera business, are likely to ship 142 million units this year vs. 29 million last year. Given the company's clean balance sheet, lack of debt, and cash of \$3.15 a share, its stock is cheap, he says. Paul Coster of J.P. Morgan Securities, which has done banking for OmniVision, rates it "overweight" and sees profits of \$1.21 a share on sales of \$399 million for fiscal 2005, and \$1.59 a share on \$472.59 million in sales for fiscal 2006.



The Online Allure Of Blue Nile's Diamonds

BLUE NILE (NILE) could be a girl's best friend—and an investor's delight. This little-known Seattle-based gem is the top U.S. online retailer of diamonds, mainly for engagement and wedding rings. It's also a leader in online specialty jewelry. Nile is among the few companies that went public in 2004 with a bang: With Merrill Lynch behind its May 19 initial public offering at 21.50 a share, Nile zoomed to 28 on opening day—and in a month sparkled at 40. It has since slid to 31. Marion Schultheis, managing director at investment firm J. & W. Seligman, says its allure is in making gem shopping simple and convenient, with all kinds of services and guarantees. She bought IPO shares for Seligman and aims to buy more. Anne-Marie Peterson of Thomas Weisel Partners has an "outperform" rating, with a 12-to-18-month target of 41 to 46. With minimal inventory and no retail stores, Nile has been "highly profitable at the early stages of growth," Peterson says. She figures Nile will earn 46¢ a share in 2004, on sales of \$160 million, and 64¢ in 2005, on \$203 million.



BusinessWeek online Gene Marcial's Inside Wall Street is posted at businessweek.com/today.htm at 5 p.m. EST on the magazine's publication day, usually Thursdays. See Gene on Fridays at 1:20 p.m. EST on CNNfn's *The Money Gang*.

Note: Unless otherwise noted, neither the sources cited in Inside Wall Street nor their firms hold positions in the stocks under discussion. Similarly, they have no investment banking or other financial relationships with them.

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"I collect timepieces. When I received my Steinhausen, I knew from the look, feel, and quality of the watch that this would be one of my favorites. I have spent thousands of dollars for inferior watches. It will be my gift of choice this holiday season." Sol S., Mt. Vernon, NY

So rare that only a handful were made in 1923

In 1923, a Swiss watchmaker crafted the most advanced watch of its time. After 80 years, the Steinhausen watch has finally been "reborn," preserving its mastery of technology and classic design.

Once only displayed in high priced collections, this rare timepiece from history can now be yours.

Step back in time to Steinhausen, Switzerland circa 1923. A master watchmaker works for months, trying to create the world's most perfect watch. Finally he succeeds—the first of its kind to display the date, day and month, and the only one to designate AM/PM.

Collectors Pay Thousands \$\$\$\$

He makes a limited number of these distinctive handmade timepieces, which eventually find their way onto the wrists of only the world's most distinguished gentry. Today, collectors are willing to pay thousands of dollars to add one of these original Steinhausen masterpieces to their own collection.

Reborn After 80 Years

Until now, that was the only way you could own a Steinhausen, still one of the world's rarest and most prized wristwatches. But for the first time in 80 years, the original Steinhausen masterpiece is now being painstakingly reproduced for modern day collectors. Still manufactured by hand, this 21st-century reproduction carries the same graceful styling and features as the original. The scratch-resistant crystal comfortably rests in a surgical grade stainless steel case and bezel, which provides the ultimate in precision and protection.

Powered by You

This handsome timepiece has been updated with a kinetic automatic movement that is powered by the motion of the wearer's arm, so the watch never needs winding or batteries.

Hand-crafted Elite Movement

The Steinhausen movement consists of 185 parts, that are assembled entirely by hand. To prevent wear on gears, fine watches use tiny gemstones to reduce friction. The Steinhausen features up to 35 jewels, 15 more than most of the worlds elite watches. The movement is then rigorously tested for flaws and accuracy. Only 6% of the movements made ever meet the stringent requirements to be placed in this noble timepiece, making the Steinhausen one of the most accurate in the world.

Adapted from Swiss Technology

A Swiss engineered movement comparable to the Steinhausen has never been produced at this low price. Each watch comes housed in a handsome storage case and includes two interchangeable leather wristbands in black and brown.

\$14.95 "Wear It and Love It" Trial Offer

Until now, most of us couldn't afford an original 1923 Steinhausen. For a limited time though, the manufacturer has decided to offer this masterpiece of technology and design to watch lovers worldwide "risk free."

In fact, they are so confident you'll love the Steinhausen masterpiece, they want you to try it on your wrist for a full 30 days for only \$14.95 plus s&h. Experience this unparalleled value for thousands less than comparable collectable watches. If not satisfied, return the Steinhausen for a full refund of the trial fee.

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Kinetic movement...never needs batteries...never needs winding!

THE HISTORY OF WATCH MAKING

1868	Steinhausen masterpiece is created	1st Automatic movement in a wrist watch	1953	Girard-Parregaux introduces the Swiss quartz watch	2003
Patek Philippe makes first wrist watch	1923	Lips produced the first battery powered watch	1966	Steinhausen masterpiece is reproduced for first time	

*\$14.95 Trial Offer entitles customers to receive one of our Steinhausen watches for review for 30 days with the right to return the watch in that period with no additional charges (minus s&h). Customers who elect to keep the watch will be billed the corresponding purchase price plus applicable taxes for the model they choose either in full or through available payment options.

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Personal Business Figures of the Week

STOCKS



COMMENTARY

It was a rough week for equities, which fell four out of five days. On Oct. 13, the Dow dipped below 10,000 before clawing its way back. Anemic jobs growth, soaring oil, and uncertainty over the election sent buyers for cover. The good news is tech earnings may be stronger than expected: Intel said its inventories fell, suggesting a positive earnings surprise.

Data: Bloomberg Financial Markets, Reuters

U.S. MARKETS

	OCT 13	WEEK	% CHANGE YEAR TO DATE	% CHANGE LAST 12 MONTHS
S&P 500	1113.7	-2.5	0.2	6.5
Dow Jones Industrials	10,002.3	-2.3	-4.3	2.4
NASDAQ Composite	1920.5	-2.6	-4.1	-0.7
S&P MidCap 400	587.4	-3.0	2.0	8.1
S&P SmallCap 600	289.3	-3.9	7.0	13.8
DJ Wilshire 5000	10,878.5	-2.6	0.7	7.0

SECTORS

			% CHANGE YEAR TO DATE	% CHANGE LAST 12 MONTHS
BusinessWeek 50*	648.8	-2.4	4.3	8.5
BW Info Tech 100**	332.0	-2.9	-5.3	-2.1
S&P/BARRA Growth	536.1	-2.7	-3.6	1.4
S&P/BARRA Value	573.5	-2.2	3.9	11.8
S&P Energy	275.6	-4.2	22.9	34.8
S&P Financials	385.9	-1.1	1.6	6.2
S&P REIT	130.1	-0.6	12.4	16.3
S&P Transportation	211.3	-1.7	4.6	13.2
S&P Utilities	128.5	-1.1	8.5	14.5
GSTI Internet	152.6	-1.6	5.5	1.6
PSE Technology	679.7	-3.5	-2.5	2.6

*Mar. 19, 1999=1000 **Feb. 7, 2000=1000

GLOBAL MARKETS

	OCT 13	WEEK	% CHANGE YEAR TO DATE	% CHANGE LAST 12 MONTHS
S&P Euro Plus (U.S. Dollar)	1192.2	-1.6	1.1	15.3
London (FT-SE 100)	4634.8	-1.5	3.5	6.2
Paris (CAC 40)	3694.3	-1.9	3.8	9.9
Frankfurt (DAX)	3976.0	-1.8	0.3	12.4
Tokyo (NIKKEI 225)	11,196.0	-1.7	4.9	2.1
Hong Kong (Hang Seng)	13,171.6	-0.8	4.7	11.1
Toronto (S&P/TSX Composite)	8729.6	-1.6	6.2	14.4
Mexico City (IPC)	10,942.4	-1.3	24.4	37.5

FUNDAMENTALS

	OCT 12	WEEK AGO	YEAR AGO
S&P 500 Dividend Yield	1.71%	1.69%	1.59%
S&P 500 P/E Ratio (Trailing 12 mos.)	19.8	20.0	29.2
S&P 500 P/E Ratio (Next 12 mos.)*	15.9	16.2	17.7
First Call Earnings Surprise*	2.27%	2.21%	8.06%

*First Call Corp.

TECHNICAL INDICATORS

	OCT 12	WEEK AGO	READING
S&P 500 200-day average	1119.9	1119.0	Negative
Stocks above 200-day average	60.0%	64.0%	Neutral
Options: Put/call ratio	0.84	0.76	Positive
Insiders: Vickers NYSE Sell/buy ratio	4.17	3.86	Negative

BEST-PERFORMING GROUPS

Photographic Products	10.0	Steel	74.0
Internet Software	9.7	Oil & Gas Refining	68.8
Computer Stores	7.1	Internet Software	63.0
Oil & Gas Refining	6.7	Internet Retail	60.3
Fertilizers & Ag. Chems.	6.6	Fertilizers & Ag. Chems.	53.7

WORST-PERFORMING GROUPS

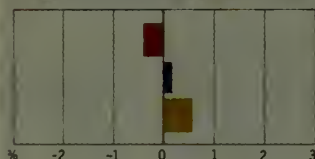
Tires & Rubber	-14.3	Airlines	-33.1
Homebuilding	-10.0	IT Consulting	-26.2
Pharmaceuticals	-9.5	Health-Care Distribtrs.	-24.3
Health-Care Distribtrs.	-7.7	Semiconductor Equip.	-23.8
Household Products	-7.4	Semiconductors	-23.5

MUTUAL FUNDS

4-WEEK TOTAL RETURN

WEEK ENDED OCT. 12

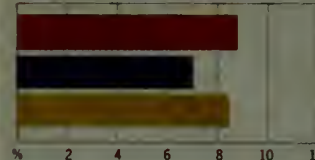
■ S&P 500 ■ U.S. DIVERSIFIED ■ ALL EQUITY



52-WEEK TOTAL RETURN

WEEK ENDED OCT. 12

■ S&P 500 ■ U.S. DIVERSIFIED ■ ALL EQUITY



Data: Standard & Poor's

EQUITY FUND CATEGORIES

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		LEADERS	
Precious Metals	10.1	Natural Resources	39.2
Latin America	8.0	Latin America	34.4
Natural Resources	6.4	Real Estate	22.9
Real Estate	4.2	Utilities	20.6
LAGGARDS		LAGGARDS	
Health	-2.9	Technology	-7.4
Japan	-1.5	Small-cap Growth	1.6
Large-cap Growth	-0.7	Large-cap Growth	1.9
Large-cap Blend	-0.4	Japan	2.3

EQUITY FUNDS

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		LEADERS	
U.S. Gl. Invs. Prec. Mnls.	17.6	ProFunds Energy Ustr. Inv.	60.6
U.S. Global Invs. Gold	17.2	iShares MSCI Austria Idx.	58.3
Oppenheimer Real Asst. A	14.0	State St. Rsch. Rsres. A	55.6
U.S. Glbl. Invs. Gl. Rscs.	12.8	ProFds. Wriss. Ulstr. Inv.	54.1
LAGGARDS		LAGGARDS	
ProFds. Phmcls. Ustr. Inv.	-13.7	ProFds. Smicdr. Ulstr. Inv.	-41.4
ProFds. Hlthcre. Ustr. Inv.	-7.6	GMO Asia III	-39.4
ProFds. Csmr. Non-Cyc. Iv.	-7.0	Thurlo Growth	-38.0
Corbin Small Cap Value	-7.0	Ameritor Investment	-31.4

INTEREST RATES

KEY RATES

	OCT 13	WEEK AGO	YEAR AGO
Money Market Funds	1.26%	1.24	0.62%
90-Day Treasury Bills	1.71	1.70	0.92
2-Year Treasury Notes	2.49	2.68	1.76
10-Year Treasury Notes	4.06	4.22	4.40
30-Year Treasury Bonds	4.87	4.97	5.29
30-Year Fixed Mortgage †	5.70	5.78	5.98

†BancQuote Inc

BLOOMBERG MUNI YIELD EQUIVALENTS

Taxable equivalent yields on AAA-rated, tax-exempt municipal bonds, assuming a 30% federal tax rate.

	10-YR. BOND	30-YR. BOND
General Obligations	3.51%	4.56%
Taxable Equivalent	5.01	6.51
Insured Revenue Bonds	3.71	4.80
Taxable Equivalent	5.30	6.86

THE WEEK AHEAD

CONSUMER PRICE INDEX

Tuesday, Oct. 19, 8:30 a.m.

EDT » Consumer prices for goods and services probably rose 0.2% in September, after a 0.1% increase in August. That's according to the median forecast of economists surveyed by Action Economics. Excluding food and energy, prices most likely climbed by 0.2% as well, after a 0.1% gain.

RESIDENTIAL CONSTRUCTION

Tuesday, Oct. 19, 8:30 a.m.

EDT » Housing starts are forecast to have eased slightly, to an annual rate of 1.96 million. In July, sales reached an annual pace of 2 million homes. Low interest rates continue to bolster housing.

INITIAL UNEMPLOYMENT CLAIMS

Thursday, Oct. 21, 3:30 a.m.

EDT » New filings for state unemployment claims most likely stood at about 325,000 during the week ending Oct. 16, from 335,000 for the week ended Oct. 2. The

string of hurricanes in September and August have been affecting recent readings. However, the upcoming numbers should once again reflect more fundamental factors in the labor market.

LEADING INDICATORS

Thursday, Oct. 21, 10 a.m. EDT »

The Conference Board's September index of leading economic indicators is expected to have held steady, after a second straight monthly decline of 0.3% in August.

The BusinessWeek production index eased to 227.9 for the week ended Oct. 2, but stood 12.4% above the year-ago level. Before calculation of the four-week moving average, the index improved to 228.

BusinessWeek online

For the BW50, more investment data, and the components of the production index visit www.businessweek.com/magazine/extra.html

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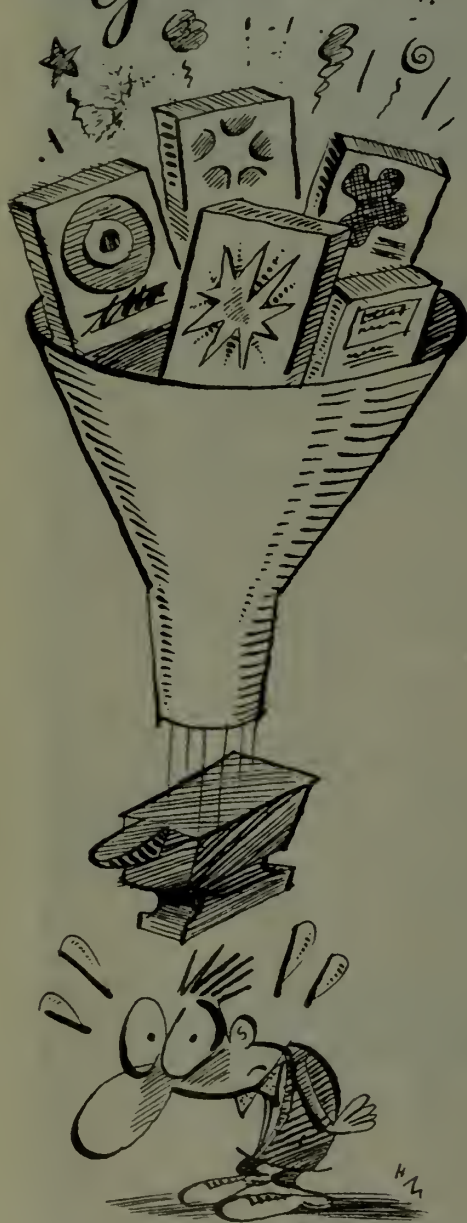
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The Job Market, Unvarnished

WHERE ARE THE JOBS? Employment growth has slowed to about 100,000 per month since July, jobs in manufacturing actually fell in September, and politicians are screaming at one another over what it all means (page 38). Republicans say that the job statistics undercount the self-employed and entrepreneurs created by the big Bush Administration tax cuts and that the unemployment rate should not be 5.4% but 5% or less. Democrats say that the same statistics underrepresent discouraged workers who have stopped looking for jobs and that the real rate of unemployment is 6% or more.

We'd like to take a nonpartisan moment (if that's possible today) to sort through the rhetoric. We think the Republicans are wrong about the unemployment rate—it probably should be higher, not lower, because the sharp decline in labor force participation indicates discouraged workers are dropping out and not being counted. And we think the Democrats are wrong about the source of unemployment—outsourcing is not the major reason for the slow job growth of this recovery. Productivity growth is the real reason.

Measuring unemployment is tricky in an economy as complex as this, but the Federal Reserve believes the payroll survey on which the Bureau of Labor Statistics calculates the unemployment rate is the best available. State tax revenues have been falling over the past three months, tracking the

softening labor market. State tax revenues tend to rise and fall with employment. They're now signaling further softness. The Republicans have it wrong on jobs.

But the Democrats don't get it, either. Of the nearly 3 million jobs lost over the past three years, only some 300,000 have been from outsourcing, according to Forrester

Both parties' explanations of the numbers fall short of the truth

Research Inc. High productivity growth through the recovery has allowed companies to cut costs and expand production without robust hiring. With oil prices staying at \$50 a barrel, they may now be trimming back hiring in anticipation of slower growth for 2005.

The fact is that companies are reluctant to hire partly because they face an unusual array of uncertainties—the Presidential election, Iraq, terrorism, energy prices, Asian competition. Some are temporary and will soon be resolved. The election is around the corner. But others will challenge the nation for decades to come. America will have to depend on what it does best—innovate—to ensure job growth and prosperity. Building protectionist walls against outsourcing is folly. Indeed, outsourcing chips and computer screens to Asia in the '90s lowered the cost of high-tech gear and spread the IT revolution. The same thing will most likely happen as low-end software, design, and other services migrate overseas. Innovation itself will become cheaper.

The U.S. has had periods of low or no job growth in the past. It does no good to simply deny them, as the Republicans do today. Nor does it do any good to blame it on outsiders, as the Democrats do. Pragmatic policies that promote innovation, productivity, and economic growth will produce lots of jobs. That's what we need today.

Public Airwaves, Private Purpose

IF THERE EVER WAS A CASE against media consolidation, Sinclair Broadcasting Group CEO David D. Smith just made it. He is ordering his 62 TV stations to run a partisan anti-Kerry documentary as news right before the Nov. 2 election. Federal Communications Commission Chairman Michael K. Powell needs to leave his ivory tower to check this abuse of power.

Powell believes that a great diversity of sources for news and entertainment is now available on the Internet and cable TV, so the consolidation of traditional TV and newspaper

ownership isn't a threat to American democracy. He wants to allow a company to own up to three local stations in the biggest media markets and permit a single company to own both a newspaper and a TV station in the same market.

The only trouble with Powell's vision is that it is more promise than reality. The high viewership of the Presidential and Vice-Presidential debates clearly shows that a huge number of Americans still get their news from TV, much of it from local stations. Consolidation of local stations can deprive them of the diversity of views they need to make informed decisions in elections. Fortunately, Congress and the courts agree and have put the brakes on many FCC proposals.

Those who doubt their wisdom should ponder the action of Sinclair Broadcasting. Sinclair has been in the forefront of lobbying for loosening FCC rules, buying up local stations around the country. Now it is force-feeding those viewers anti-Kerry propaganda. Months ago it refused to run an ABC *Nightline* show where Ted Koppel read the names of Americans killed in Iraq. Those that license the public airwaves have a civic responsibility to show a modicum of fairness.

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